Spotlight on Accounting Errors

Going Concern – Double Jeopardy!

Following a corporate collapse, it is common for the failed company directors and management to be in the spotlight regarding their failure to adequately disclose the uncertainties and risk about the ability of the entity to continue as a going concern and the key judgements applied in making their assessment that the entity could continue as a going concern.

Failure to disclose the key judgements applied in determining that there were no material uncertainties regarding the entity's ability to continue as a going concern, can be a reason for litigation against company directors, management, and their auditors of failed companies.

An entity is no longer a going concern if management either intends to liquidate the entity or cease trading or have no realistic alternative but to do so. In assessing an entity's ability to continue as a going concern, all relevant information up to the date the financial statements are issued must be considered. Directors and management should consider all available information with a particular focus on determining whether the entity will have sufficient liquidity to pay its debts as and when they fall due at least, but not limited to, twelve months from the date the financial statements are issued.

Where there is the potential that an entity may not continue as a going concern the required disclosures in IAS 1 / AASB 101 *Presentation of Financial Statements* to be made regarding an entity's going concern assessment is a double-edged sword:

1. Disclosures regarding material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, as required by IAS1 / AASB 101 paragraph 25; and
2. If the directors and management have determined that there are mitigating factors such that the uncertainties regarding the entity's ability to continue as a going concern are not 'material uncertainties' to be disclosed in accordance with AASB 101 paragraph 25, the significant judgements applied that alleviate the uncertainty should be disclosed in accordance with IAS 1 / AASB 101 paragraph 122.

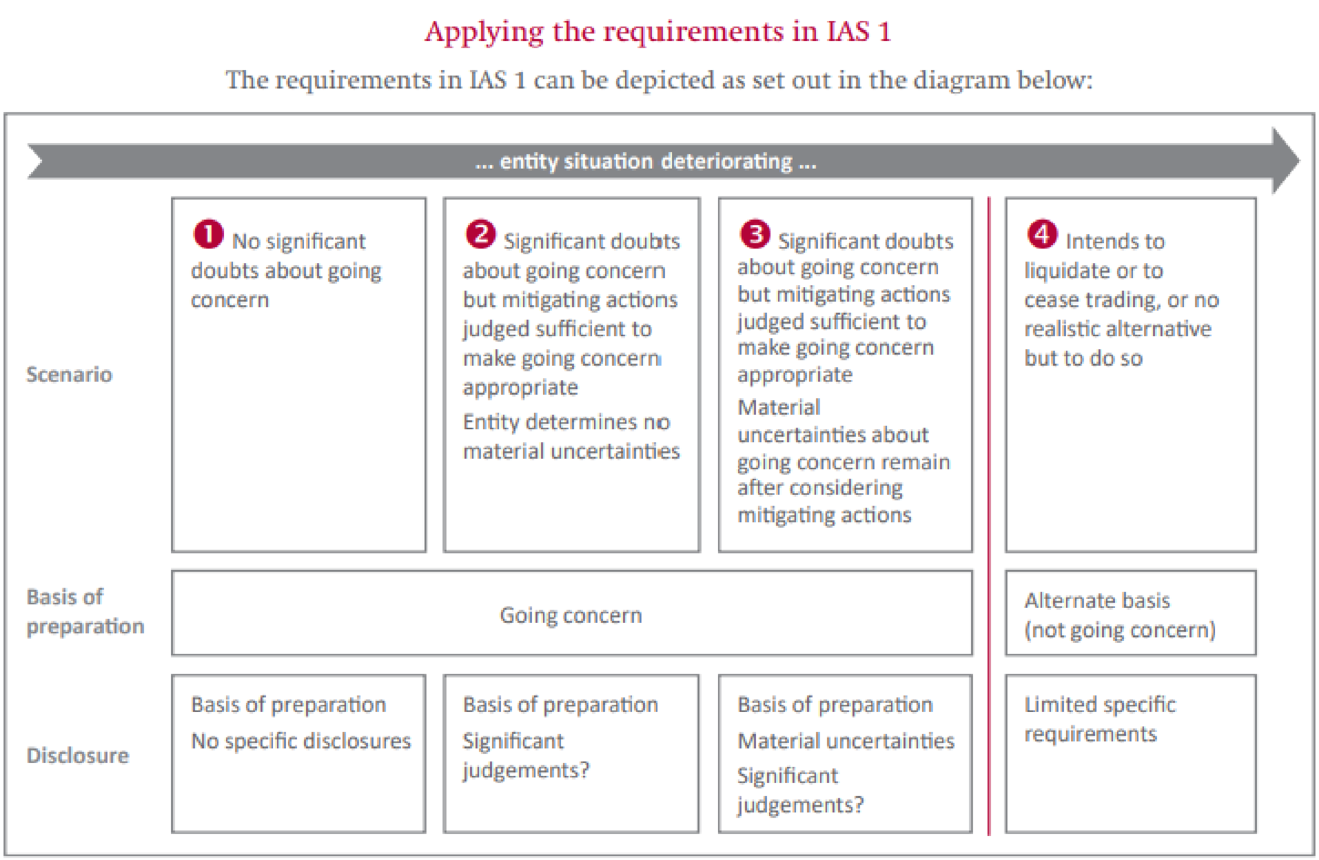
Typically, when entities consider their going concern disclosure obligations, they address the issue of whether there are material uncertainties that require disclosure in accordance with AASB 101 paragraph 25, failing to provide information regarding management's evaluation of the significance of those conditions or events and plans that led them to conclude that those uncertainties were not material as required by AASB 101 paragraph 122.

Applying the requirements in IAS 1 / AASB 101

This accounting error was considered by the IFRS Interpretations Committee in 2014 and reiterated in January 2021 by the IASB in their paper *Going Concern – A Focus on Disclosure* issued by the IASB to support the consistent application of requirements in IFRS Standards. The IASB noted the following:

> *Management's decision will be underpinned by assumptions and judgements that, in the current environment, may involve more uncertainty than in the past. It is important therefore that an entity considers not only the specific disclosure requirements relating to going concern in paragraph 25 of IAS 1 but also the overarching disclosure requirements in IAS 1. These requirements include those in paragraph 122 relating to judgements that have the most significant effect on the amounts recognised in the financial statements. In the current stressed economic environment, users of financial statements are more likely to focus on disclosures relating to going concern. Questions that users might ask could include how the assumptions management has used in reaching its conclusion about going concern relate to assumptions underpinning other aspects of the financial statements.*

The IASB set out the following diagram to outline the application of the requirements of IAS 1 / AASB 101 as it relates to an entity's going concern assessment and disclosure requirements:



In considering what disclosure needs to be provided, directors and management should be very aware of where on the continuum the entity sits. The IASB paper highlights the following:

Scenario 1 applies:

> *At one end of the going concern range, in Scenario 1, is an entity that has profitable operations and has no liquidity concerns and for which there are no significant doubts about its ability to continue as a going concern. For such an entity, apart from the need to describe the basis of preparation, there are no specific disclosure requirements relating to going concern. It is also less likely that significant judgements were involved in reaching the conclusion to prepare the financial statements on a going concern basis.*

Scenario 3 applies:

> *At the other end of the going concern range, in Scenario 3, is an entity that is close to ceasing to be a going concern. Assume the entity is loss-making, demand for its goods or services has decreased rapidly and its funding facilities are due to expire in the next 12 months. In this scenario, management has concluded after considering all relevant information— including the feasibility and effectiveness of the actions it plans to take—that preparing the financial statements on a going concern basis is appropriate. Nonetheless, management concludes there are material uncertainties relating to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern—for example, there might be considerable uncertainty about management's ability to execute its turnaround strategy to address the reduced demand and to renew or replace funding. In such a scenario paragraph 25 of IAS 1 requires an entity to disclose the material uncertainties relating to its ability to continue as a going concern. In doing so, the entity identifies that those uncertainties may cast significant doubt upon its ability to continue as a going concern.*
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> *In Scenario 3, the conclusion to prepare the financial statements on a going concern basis is likely to have involved significant judgement. If this is the case, in addition to disclosing the material uncertainties as required by paragraph 25, the entity is also required to apply the disclosure requirements in paragraph 122 relating to the judgement that the going concern basis is appropriate. In applying these requirements, the entity considers what information is material about:*
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> *(a) the events or conditions that cast significant doubt upon the entity's ability to continue as a going concern; and*
>
> *(b) the feasibility and effectiveness of management's actions or plans in response to those events or conditions.*

Scenario 2 applies:

> *Assume that the facts are similar to Scenario 3 except that after considering the feasibility and effectiveness of the actions it plans, management concludes that the material uncertainties are expected to be mitigated—for example, management might have started executing a turnaround strategy that is showing sufficient evidence of success including identifying feasible alternative sources of financing. The Interpretations Committee considered a similar scenario in 2014. In its Agenda Decision the Committee highlights that if, after considering planned mitigating actions, management's conclusion that there are no material uncertainties involves significant judgement, then the disclosure requirements in paragraph 122 would apply to the judgements made in concluding that no material uncertainties remain.*
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> *Another example of overarching disclosure requirements in IAS 1 that could also be relevant, especially in cases of close calls, are the requirements relating to sources of estimation uncertainty in paragraphs 125–133. These paragraphs require an entity to disclose information about the assumptions it makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year.*

Going Concern – the requirements of IAS 1 / AASB 101

IAS 1 / AASB 101 requires the following:

Paragraph 25

> *When preparing financial statements, management shall make an assessment of an entity's ability to continue as a going concern. An entity shall prepare financial statements on a going concern basis unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so. When management is aware, in making its assessment, of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, the entity shall disclose those uncertainties. When an entity does not prepare financial statements on a going concern basis, it shall disclose that fact, together with the basis on which it prepared the financial statements and the reason why the entity is not regarded as a going concern.*

Paragraph 26

> *In assessing whether the going concern assumption is appropriate, management takes into account all available information about the future, which is at least, but is not limited to, twelve months from the end of the reporting period. The degree of consideration depends on the facts in each case. When an entity has a history of profitable operations and ready access to financial resources, the entity may reach a*

conclusion that the going concern basis of accounting is appropriate without detailed analysis. In other cases, management may need to consider a wide range of factors relating to current and expected profitability, debt repayment schedules and potential sources of replacement financing before it can satisfy itself that the going concern basis is appropriate.

Significant judgements – the requirements of IAS 1 / AASB 101

IAS 1 / AASB 101 requires the following:

Paragraph 122

An entity shall disclose, along with its significant accounting policies or other notes, the judgements, apart from those involving estimations (see paragraph 125), that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements.

Paragraph 125

An entity shall disclose information about the assumptions it makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year. In respect of those assets and liabilities, the notes shall include details of:

(a) their nature, and

(b) their carrying amount as at the end of the reporting period.

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