CFRR

Centre for Financial Reporting Reform

WORLD BANK GROUP
Governance

GROUP EXERCISE

Going Concern Judgements

Audit Training of Trainers

EU REPARIS

EU-REPARIS is funded by the European Union and is a part of WB EDIF.

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Contents

Acknowledgments

This group exercise was developed by Kalina Shukarova Savovska, Senior Financial Management Specialist, Centre for Financial Reporting Reform (CFRR), The World Bank, as part of the Audit Training of Trainers (Audit ToT) Program delivered under the EU-REPARIS program. The facts of the case further build on the simulated audit client case study "PejaSko Cheese Ltd." used throughout Audit ToT workshops. The CFRR team wishes to thank the participating trainers, institutions and Professional Accountancy Organizations (PAOs) for their input during the October 2-3, 2017 Audit ToT Workshops in Vienna when this exercise was piloted (listed below in order of country):

- Institute of Authorized Charted Auditors of Albania (IEKA)
- Association of Accountants and Auditors of Republika Srpska (AAARS)
- Union of Accountants, Auditors and Financial Workers of Federation of Bosnia and Herzegovina (SRRF-FBH)
- Auditors Chamber in the Federation of Bosnia and Herzegovina
- Institute of Certified Public Accountants of Bulgaria
- Croatian Audit Chamber
- Estonian Auditors' Association
- Society of Certified Accountants and Auditors of Kosovo (SCAAK)
- Institute of Certified Auditors of the Republic of Macedonia (ICARM)
- Council for Advancement and Oversight of the Audit (CAOA)
- Institute of Certified Accountants of Montenegro (ICAM)
- Philippines Board of Accountancy
- Chamber of Financial Auditors of Romania (CAFR)
- Chamber of Authorized Auditors of Serbia (CAA)
- Serbian Association of Accountants and Auditors (SAAA)

Introduction

Objective

The objective of the group exercise is to enhance the analytical and intellectual skills of participating trainers while engaging in a practical case study involving going concern judgements.

Gathering appropriate evidence and evaluating the appropriateness of the going concern assumption, as well as making judgements about whether a going concern issue is present, are affected by the size of the entity. Auditors in small- and medium-sized practices (SMPs) face specific challenges when auditing going concern in their SME clients. It is therefore critical for SMP practitioners to develop a wide range of analytical and intellectual skills including abilities to apply sound professional judgement to reach well-reasoned conclusions based on facts.

Background Information

ISA 570 (Revised) Going Concern deals with the auditor's responsibilities relating to going concern and the implications for the auditor's report.

Going concern basis of accounting

The going concern basis of accounting assumes that assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business. Under the going concern basis of accounting the financial statements are prepared on the assumption that the entity is a going concern and that its operations will continue in the foreseeable future, unless the entity is liquidated or ceases operations. The audit covers the same period as management's assessment to evaluate the entity's ability to continue as a going concern. This period should be at least, but not limited to, twelve (12) months from the end of the reporting period.

Material uncertainty (i.e. a going concern "issue")

A material uncertainty exists when events or conditions may cast significant doubt on the entity's ability to continue as a going concern. These conditions, events, and indicators, may be financial (e.g. withdrawal of financial support by creditors), operating (loss of key management without replacement), or other (e.g. uninsured or underinsured catastrophes). The existence of one or more of these indicators may not always signal that a material uncertainty exists and the significance of these events can be mitigated by other factors. Consideration of these indicators at the planning stage helps the auditor determine whether

going concern is likely and is an important issue. It also allows for more timely discussions with management, and resolution of any identified going concern issues.

Considerations for smaller entities

Smaller entities are affected by their size when it comes to their ability to withstand adverse conditions. Smaller entities may not, for example, have sufficient reserves to withstand the loss of a major customer, supplier, or key employee; they may encounter issues in their right to operate under a license or franchise; and there is the risk that banks and lenders may cease support of the entity should difficulties in operations be encountered. Continued support from the owner – manager is very important to the ability of smaller entities to continue as a going concern; often in financial difficulties a personal guarantee of the owner-manager with his personal assets as collateral is an important factor. In these conditions, the auditor may request written confirmation from the owner-manager elaborating the intention, terms, and conditions of such support.

Further the management of smaller entities often rely on in-depth knowledge of the business and anticipated future prospects rather than preparing a detailed assessment of the company's ability to continue as a going concern. Nevertheless, to meet the requirement of ISA 570 (Revised) Going Concern, the auditor will need to evaluate management's assessment and be satisfied, through discussion, inquiry, and inspection of supporting documentation, that the going concern assumption is appropriate.

Approach and Format

This group exercise further builds on the facts presented in the simulated audit client case study "PejaSko Cheese Ltd.", that is used throughout the Audit Training of Trainers modules.

Participants are asked to read through the Scenario (part A) and apply the Audit Firm Methodology (part B) in order to complete the assignments divided around two stages of the audit: (i) Assignments based on circumstances at the planning stage; and (ii) Assignments based on circumstances at year end. Participants use the Template: Going Concern Working Paper (part C) to record their work at both stages of the audit. Approximately 40 minutes are provided for the group work and table discussions.

The moderator initiates a group discussion (for approximately 20 minutes) and reflects with participants on judgments and conclusions regarding the going concern. The results of the participant discussion as well as the trainers guide is provided in Part D.

Expected Outcomes

- Develop and enhance participants' analytical and intellectual skills while engaging in a practical case study involving going concern judgments;
- Obtain evidence, document, and conclude on the appropriateness of the going concern assumption in a small client context; and
- Build awareness that SMPs face specific challenges when auditing the going concern in their SME clients caused by the size of the entity; it is critical for these practitioners to develop a wide range of analytical and intellectual skills including abilities to apply sound professional judgement to reach well-reasoned conclusions based on facts.

Part A: Scenario

PejaSko Cheese Ltd. ("PejaSko" or "PC") is a small sized producer of pasteurized and unpasteurized sheep and goat cheese, which produces its own cheese to sell locally and for exportation. Customers vary from medium size grocery store chains to smaller independent stores. Exports to neighboring countries account for approximately 20 percent of the company's sales. The company has a share capital with a nominal value of EUR 20,000 equivalent in local currency. The Chairman of the board and the company's founder — Svetozar Brankomat — owns 85 percent of the company's shares while a group of 10 local farmers own the remaining 15 percent. The company's board also consists of Vesna Nebesna (Chief Accountant) and Gego Bioncev (lawyer).

You are hired as an assistant auditor with Best Audit Ltd. and are participating in the audit of PejaSko. One of your tasks has been to gather information and evidence to support the going concern basis of accounting of PejaSko.

Circumstances Present at Planning Stage

While performing planning procedures, the following comes to your attention:

- The table below provides the company's key figures and compares last year's financial results and budget:

In euro million (converted from local currency)	Last year - Actual	Last year - Budget	Actual vs Budget (€million)	Actual vs Budget (%)
Revenue	1,30	1,60	(0,30)	(19%)
Cost of sales	0,60	0,50	0,10	20%
Payroll	0,25	0,20	0,05	25%
Other operating expenses	0,20	0,15	0,05	33%
Depreciation	0,12	0,12	-	0%
EBIT*	0,13	0,63	(0,50)	(79%)
Net financial costs	0,05	0,03	0,02	67%
Income taxes	0,01	0,10	(0,09)	(90%)
Net profit	0,07	0,50	(0,43)	(86%)

**Earnings Before Interest and Tax.*

In euro million (converted from local currency)	Last year -Actual	Last year - Budget	Actual vs Budget (€million)	Actual vs Budget (%)
Fixed assets	0,30	0,42	(0,12)	(29%)
Current assets	0,60	0,45	0,15	33%
Equity	0,10	0,10	-	0%
Long term liabilities	0,20	0,30	(0,10)	(33%)
Short term debt	0,10	0,21	(0,11)	(52%)
Other liabilities	0,50	0,26	0,24	92%

- The current year's financial performance has not been great for PejaSko: sales have continued to decrease this year, given the slow movement in the economy and the increased competition in the market segment. Mr. Brankomat is confident that this is just a temporary situation as the quality of the cheese and the company's reputation is impressive.
- The company's revenues have decreased over the last six years mainly due to increased competition and unfavorable economic conditions. Customers are not particularly loyal to one brand of cheese or to one producer and there are many players so the market could be volatile, especially in cases of bad press or issues with product quality.
- Exports to neighboring countries comprise approximately 20 percent of sales. Customers for the company's cheeses include: an international grocery chain which accounts for 100 percent of export sales; two local grocery chain, which account for 70 percent of domestic sales; and approximately 30 different family owned shops and supermarkets around the country, which account for 30 percent of domestic revenue. The biggest threat for the company in the short term is to lose one or two of the chains which collectively account for about 50 percent of PejaSko's turnover. Work is therefore focused on reducing PejaSko's dependency of these chains by securing more small retail companies and increasing exports.
- The collection of accounts receivables has always been a problem for the company. PejaSko has two main customer types: grocery chains and individual shop owners. Grocery chains have long payment terms – 60 days and they rarely pay on time. Individual shop owners have much shorter payment terms – the standard is 14 days, but they too never pay on time and major payment delays are not unusual.
- The company's liquidity position is stable although it has temporary cash-flow problems, which is why an overdraft facility - an open line of credit - was established. The overdraft is being used to finance any current deficits and the repayment of current liabilities, including liabilities for purchasing raw milk from local farmers.

- Other operating expenses include the cost of business trips for Mr. Brankomat and his family to various West European locations in order to "investigate potential export opportunities and market exploration". These trips are consistent with strategy to expand export sales to EU markets.
- On 5 January, part of the inventory of unpasteurized goat cheese was returned to the company by a couple of local stores. The cheese was counted and included in the inventory balance at the year-end and included in the stock-take on 31 December. According to the explanation provided, this inventory was returned because the shop owners complained that their customers had experienced stomach problems after eating cheese from a particular batch. The company owners maintained that the stomach problems had been caused by "too much celebrating on New Year's Eve, as usual", rather than the quality of product, especially since "this has never happened in the past". The company is planning to rebrand the cheese from this batch and resell it at a discounted price to a local grocery chain in mid-January.
- On 30 December one of the barns, which was being renovated, caught fire and completely burned down. Luckily, this happened during the day when the animals were outside so no major damage occurred to the livestock. The barn was insured and PejaSko included the expected receivable amount of EUR 200,000 from the insurance company in the financial statements.
- The company's Chairman is closely involved in the company's operations - he likes to have the final word regarding any decision affecting operations. He is middle aged and has a son and a daughter who could potentially follow in his footsteps in the future. At the moment, they are mainly interested in art and travel and are not really engaged in the business. Mr. Brankomat's state of health is unknown, but there are some indications that he should take a closer look at these aspects in the future. When he broke his leg two years ago it caused a lot of inertia in the company's decision-making process. Luckily, this happened in the low-season so the business was not too adversely affected.

Assignments at Planning Stage:

- Using the Template: Going Concern Audit Working Paper (part C) to document the work performed regarding going concern during the planning.

Circumstances at Year End

At year end while performing closing procedures you revisit the going concern conclusions. The following developments and circumstances have come to your attention:

- Subsequent to year-end but before the financial statements are released, a group of unhappy customers who experienced severe stomach problems after consuming unpasteurized goat cheese from the PejaSko brand, have filed a group law suit against the

company claiming damages for hospital bills sustained and seeking compensations due to long term negative consequences to their health. The claimants have widely publicized the incident through TV, social media, and in newspapers attracting lots of damaging publicity for PejaSko. Rumors have spread expressing concerns with the quality of PC's products.

- As a result of the law suit and the damaging publicity, an alarming number of stores began to cancel orders from PC claiming that customers have stopped demanding the PejaSko cheese brand. Frequent health inspections and checks, conducted by the heath authorities in respect of the ongoing litigation, have caused disruptions and delays in the production process. Important orders for foreign markets were not supplied on time. These delays, together with the negative publicity, resulted in the loss of the major international grocery chain which accounted for 100 percent of export sales.
- Traditionally, the company has been mainly profitable and has been able to provide its shareholders with solid and profitable earnings. However, for the first time since its establishment, dividend payment has been discontinued based on an extraordinary shareholders meeting when financial concerns regarding the future of the company operations had been addressed and discussed among shareholders.
- Mr. Brankomat is confident that these unfortunate developments will be mitigated by the strategy of the company to invest further in the quality of the production process and develop new and healthy lactose free products, as well as plans to enter the EU market. He supports the going concern assumption. PejaSko has long lasting relationships with the banks who will continue to support the business. Mr. Brankomat plans to make an additional investment in the company through a subordinated loan after selling a large plot of land traditionally held by the Brankomat family. He is determined to personally lead the business out of these difficult times and if necessary will guarantee its going concern with his personal holdings and wealth.
- However, due to ongoing pressures and stress caused by the accusations and bad publicity of PejaSko, Mr. Brankomat's health has suffered and he has been hospitalized. Doctors have strictly forbidden him from leaving bed rest. Mr. Brankomat's son, has stepped in to help out by running the business until his father's health situation improves. Unfortunately, this is taking longer than he anticipated and he is becoming impatient in his current role. He has disclosed that a company competitor expressed interest in acquiring some of the company production assets at a reasonable price but no negotiations are presently ongoing.
- Ms. Vesna Nebesna has prepared the financial statements and the notes include the following disclosures:

  "Basis of preparation - Going Concern: *The company lost a major customer who due to negative conditions and damage of reputation withdrew all its further orders which accounted for 20% of total sales. Further, due to bad publicity, sustained demand for*

Company products has suffered and as a result management has taken measures to reflect the reduced revenues in the business that include suspension of dividend payment and sourcing additional funds for investing in new technology to modernize the production process into new segments and markets.

The Company directors have concluded that a material uncertainty exists that casts significant doubt upon the company's ability to continue as a going concern and that, therefore, the company may be unable to realize its assets and discharge its liabilities in the normal course of business. However, given the continuing efforts to secure new markets and customers, the directors continue to adopt the going concern basis of accounting.

Note on Subsequent Events: *Subsequent to year end a group of customers have sued the company for damages and sustained loss of approximately XY Euros. Based on legal advice obtained, management will soon be filing a counter law suit for damage of reputation and lost business in equivalent amount. Management is confident that no losses will be sustained in respect of this litigation and the company will successfully defend the ongoing case.*

Assignments at Year End:

- Using the Template: Going Concern Audit Working Paper (part C) to document the work performed regarding going concern during year end.

Part B: Audit Firm Methodology

The audit firm methodology is consistent with the requirements of IAS 570 (Revised) Going Concern. The methodology recognizes that the extent of the procedures does not need to be elaborate in all cases. For example, the procedures do not need to extend to detailed examination of budgets and forecasts should the entity operate in uncomplicated circumstances. Further, many of the going concern audit procedures are already performed in the context of the audit but these should be modified and extended in circumstances when a potential going concern issue is identified.

Illustrative Audit Procedures

A non-exhaustive list of firm procedures in respect of going concern are presented below that should be extended and adapted to suit particular circumstances:

Going Concern: Illustrative Audit Procedures

Mandatory procedures (performed on all audits at planning and updated at year end):

- While gaining an understanding of the entity and its related business risks, analyze if there are one or more indicators that individually or in combination may cast significant doubt on the company's ability to continue as a going concern;
- Consider if there is evidence from other procedures, such as work performed on accounts receivable, inventory, or long term liabilities, that may cast significant doubt on the company's ability to continue as a going concern;
- When the entity is dependent on financial support from a parent company (by means of borrowings, extended intercompany balances, or access to goods and services) consider if the parent company has the ability to continue to provide the support in the future;
- Ask management / those charged with governance how they have satisfied themselves that the going concern is appropriate and whether they have any knowledge of business risks, events, or conditions that may cast significant doubt on the company's ability to continue as a going concern.

Procedures to investigate potential going concern issues:

- Investigate events after the balance sheet date and identify issues that may affect the ability of the company to continue as a going concern;
- Review recent financial information for evidence of improvement or deterioration of financial position;

- Review minutes of meetings of shareholders, board of directors, and other sources of information and investigate if there have been discussions related to financial difficulties;
- Ask lawyers about litigations and claims;
- Review terms of borrowing agreements and facilities to determine if any covenants have been breached;
- Review management cash flows, forecasts, and budgets and consider if these are reliable, including underlining data.

Procedures to evaluate a going concern issue (gathering evidence to determine whether a material uncertainty exists):

- Review management's plans for future actions based on the going concern assessment;
- Obtain written representations from management concerning plans for the future to improve the financial situation;
- Analyze and discuss with management cash flows, forecasts, and other relevant financial information just prior to the signing of the financial statements;
- Review financing facilities, related party balances and other commitments and evaluate any consequences should there be no possibility to extended these beyond their due dates;
- Evaluate the reliability of third party support letters;
- Determine if the disclosures of the going concern is required /adequate.

Illustrative Indicators

The indicators below may provide considerations when assessing the going concern of an entity:

Going Concern: Illustrative Indicators
Current financial issues
• Net liability, or particularly a net current liability position
• Recorded operating losses or reoccurring operating losses over several years
• Deterioration in the value of assets used to generate cash flows
• Dividends in arrears or discontinuance of dividend payments

Going Concern: Illustrative Indicators

- Unfavorable or adverse key financial ratios (for example working capital ratio, gross profit ratio, inventory turnover, times interest earned, debt to equity ratio)

Cash flow and liquidity issues

- History of operating cash flows being significantly less than operating profits
- Negative operating cash flows, indicated by historic or prospective financials
- Increases in debtors and inventory without matching increases in cash flow
- Evidence of slowing in payments to creditors on due dates
- Evidence of slowing in collections from debtors
- Cash revenues insufficient to cover interest outgoings
- Growing expenditure on research without corresponding increases in cash flow
- Lack of sustainable cash flows from core business activities
- Significant growth of the entity making large cash drains on the organization

Financing arrangements

- Borrowings and bank overdraft facilities approaching maturity with uncertainty as to prospects of renewal or repayment
- Borrowings excessively based on non-cash generating revaluations of assets
- Excessive reliance on short-term borrowings to finance long-term assets
- Difficulty in complying with the terms of loan agreements or the need to restructure debt
- Inability to obtain financing for necessary new product development or other investments
- Disposing of substantial assets to generate funds
- Indications of withdrawal of financial support by creditors

Business risks

- Concentration of risk in a limited number of products or projects
- Rapid or unplanned development of business or expansion into non-core areas
- Declining industry or pressure on the industry from a declining economy
- Failures of other entities in the same industry
- Technical developments which render a key product obsolete

Going Concern: Illustrative Indicators
• Undue influence from a market dominant competitor • Adverse changes or likely changes in legislation or government policy • Pending legal or regulatory proceedings against the entity • Loss or likely loss of a major market, franchise, or license • Shortages of important supplies or loss of principal supplier • Uninsured or underinsured disasters such as drought, flood, fire, fraud, or sabotage **Operational and management issues** • Excessive reliance on transactions with related parties • Lack of budgets and cash flow forecasts • Deficiencies in management information systems • Lack of adequate back-up and recovery procedures • Lack of management response to information received • Loss of key management without replacement • Instances of non-compliance with capital or other statutory or legal requirements

Reporting Guidelines

The firm methodology provides the following guidelines in respect of going concern:

Reporting Guidelines
Going concern basis of accounting is appropriate and no material uncertainty exists: • Even when no material uncertainty exists, the auditor needs to evaluate whether in the view of the requirements of the applicable financial reporting framework there is adequate disclosure. • When ISA 701 applies, the auditor may consider certain events or conditions related to going concern to be determined as Key Audit Matters. **Going concern basis of accounting is appropriate but material uncertainty exists:** • An unmodified opinion is issued when adequate disclosure is made in the financial statements. The auditors' report includes a separate section in audit report "Material Uncertainty Related to Going Concern" when adequate disclosure is made. No emphasis of matter, unless required by law or national regulation / standards.

- Qualified or Adverse opinion if adequate disclosure is not made in the financial statements or in cases when management is unwilling to extend its assessment when requested to do so by the auditor.
- Disclaimer of opinion is considered in rare situations involving multiple uncertainties that are significant to the financial statements as a whole.

Going concern basis of accounting is not appropriate:

- Adverse opinion if management's use of the going concern basis of accounting in the preparation of the financial statements is inappropriate. In these circumstances, another basis (e.g. liquidation basis) is deemed appropriate and it is irrelevant if appropriate disclosures are made regarding the inappropriateness of management's use of the going concern basis of accounting.

Part C: Template "Going Concern Audit Working Paper"

Company Name: PejaSko Cheese Ltd.
Year end: 31 December
Objective: Obtain evidence, document, and conclude on the appropriateness of the Going Concern assumption.

Prepared and Reviewed by:	
Date:	

Procedures at planning:	Documentation:
Mandatory procedures: • Identified indicators of going concern • Document any mitigating factors	
When a potential going concern issue is identified: • Document additional procedures performed • Results of work performed	
Conclusion statement at planning: • Is the going concern basis appropriate or not • Factors that support this conclusion.	
Procedures at Year End:	**Documentation:**
Follow up procedures and results of work performed during update at year end	
Reaffirmation or Reconsideration of Conclusion statement at year end: • Is the going concern basis appropriate or not • Factors that support this conclusion	
Implications for the Auditor's Report:	

Part D: Trainers Guide

The proposed solutions have been complied based on the discussions and exchange of opinions among members of the Audit ToT Community of Practice during the October 2-3, 2017 workshop when this group exercise was piloted. Any audit engagement is however unique and subject to the exercise of professional judgment on behalf of the auditor. The proposed audit approach, documentation examples and conclusions shown below are therefore just one way to approach the exercise of professional judgment on behalf of the auditor in a small audit context.

Circumstances at planning stage

At the planning stage the auditor will perform mandatory going concern procedures that are performed on all audits at planning and updated at year end. These will include a review of any indicators that individually or in combination may cast significant doubt on PejaSko's ability to continue as a going concern. Some identified indicators and mitigating factors identified during the participant discussion include:

Identified Going Concern Indicators:	Mitigating Factors:
Possible cash-flow and liquidity issues	Availability of bank overdraft to overcome cash shortage due to customer payment delays. Company CEO is committed to support the company with his personal wealth
High concentration of customers	There is a strategy to diversify and focus more on small retail companies as well as increase sales in foreign markets
Product quality issues due to customer returns	Well-known brand with good reputation
Health situation of CEO	Succession by CEO's children is possible
Damage of property (fire in the barn)	The property (barn) is adequately insured against damage caused by fire and insurance reimbursement is expected
Decreasing revenues, falling profit margin and high competition in the market	Company is considering investing in new markets and lactose free products

Because of the mitigating factors identified above, at the planning stage, the auditor concludes that there is no going concern issue identified and that the going concern basis of accounting is adequate for PejaSko.

Circumstances at year end

At year end, the circumstances have changed significantly. Because of the deteriorated conditions, the auditor performs additional procedures to investigate the potential going concern:

- Loss of major customer accounting for 20% of sales and review of management plans, budgets, forecast based on changed circumstances;
- Review of subsequent events and most recent financial information to evaluate the impact to revenues considering of the negative publicity and damaged reputation which may be difficult to recover;
- Obtaining a legal letter and discussing with lawyers regarding the impact of the litigation, legal expenses and possible damages and penalties;
- Review of terms of borrowings and financing arrangements, including the likelihood of these being renewed under the changed circumstances of PejaSko.

Because the significance of these conditions, the auditor performs additional procedures, including evaluating the going concern issue and gathering evidence to determine whether a material uncertainty exists.

The CEO, Mr. Brankomat, is willing to support PejaSko with his personal wealth. He plans to use the proceeds from sale of family owned land to support the business during difficult times. However, as Mr. Brankomat's health has deteriorated and since he is hospitalized, he is unable to perform his duties. Mr. Brankomats' son has taken over as acting CEO but he may not be as willing to support the business in the same manner as his father. He may be considering a piecemeal sale of assets to a competitor. Because of these conditions, the auditor will need to secure a support letter, signed by the CEO / majority shareholder and acting CEO, that confirms in writing that sale proceeds of land owned by the personal estate of the Brankomat family will be used to support the business should other financing sources be unavailable. The auditor will also need to ensure that the land is available for immediate sale (e.g. ownership and title is appropriate) and that there are no restrictions surrounding the sale (e.g. mortgages).

Provided the above support letter is received signed, and the land is available for immediate sale, then the auditor's report should remain unmodified as adequate disclosure is made and should include a in the report a separate section "Material Uncertainty Related to Going Concern".