

Going Concern disclosures in financial statements

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Introduction

The adoption of the going concern assumption is one of the fundamental accounting concepts used in the preparation of financial statements. An entity that cannot rely on the going concern assumption may be unable to realise its assets and discharge its liabilities in the normal course of business. As a consequence, the values of those assets and liabilities may well be impaired in its financial statements. This might have significant impact on the value of an investor's investment. Because of this potential adverse impact on investors, FMA has focused its financial statement monitoring on good disclosure surrounding going concern. This monitoring has been performed to ensure that where going concern issues have been identified, disclosure is appropriate.

The purpose of this report is to inform market participants of the findings of our review and highlight areas of concern. It also:

- reminds directors of the importance of the going concern assumption when preparing accounts using New Zealand GAAP and disclosure requirements
- considers the requirements of New Zealand Auditing standards and whether the audit opinion is in compliance with these standards.

Going Concern

NZ IAS 1 *Presentation of Financial Statements*¹ requires those charged with governance to:

- make an assessment of an entity's ability to continue as a going concern, and
- where there are material uncertainties that may call this into doubt, disclose those uncertainties in the annual report.

Practically, NZ IAS 1 gives little specific guidance on how to approach the assessment of going concern issues; however audit standards do provide guidance in the form of ISA (NZ) 570 *Going Concern*.

It is important that investors are provided with all material facts relating to the use of the going concern assumption to provide them with assurance about its use. If an entity is subject to material uncertainties related to events or conditions that could cast significant doubt on that entity's ability to continue as a going concern, the matter of whether that entity can appropriately claim to be a going concern is of significant importance.

When the auditor believes there is material uncertainty that might affect the going concern assumption and that uncertainty is disclosed by the organisation, the auditor will draw the reader's attention to this by adding an *Emphasis of Matter* (EoM) paragraph to the audit report.²

¹ NZ IAS 1, Paragraphs 25 & 26

² As required by ISA (NZ) 570, Paragraphs 18, 19 & 20



The Chartered Financial Analyst (CFA) Institute report *Financial Reporting Disclosures: Investor Perspectives on Transparency, Trust, and Volume* July 2013 identified that with respect to going concern investors required:

- disclosure of risks that directly or indirectly affect a determination that there is a question as to whether an entity is still a going concern
- disclosure of the expected course of action that will bear on the financial flexibility of an entity and a reasonably detailed discussion about the entity's ability to generate sufficient cash to support its operations, during at least the 12 months from the date of the financial statements.

FMA's review of issuers' going concern disclosures

We selected a sample of 56 entities to review their going concern disclosures. Of these, four entities prepared their financial statements using the realisation basis (i.e. they were not a going concern). Of the 52 prepared on a going concern basis, five received audit "Disclaimers of Opinion", one received a qualified audit opinion and the remaining entities received EoM paragraphs in their audit reports. The financial statements reviewed were primarily for the 2013 period.

Our review focused on the entity's going concern disclosures and whether those disclosures were consistent with the audit reports of those financial statements.

Findings

Use of the *Emphasis of Matter* option in Audit reports

The audit standard ISA (NZ) 706 *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report* sets out the conditions for the use of these discretionary paragraphs in an audit report. It emphasises in its guidance³ that "A widespread use of *Emphasis of Matter* paragraphs diminishes the effectiveness of the auditors' communication of such matters".

When an auditor adds an EoM paragraph to an audit report where a material uncertainty is identified, the reporting entity should include all of the following components in their going concern disclosure in the financial statements:

- The directors' view of whether the going concern basis was appropriate.⁴
- A description of the principal events or conditions that may cast doubt on the going concern basis.⁵

³ ISA (NZ) 706, Paragraph A2

⁴ NZ IAS 1 Paragraphs 25 & 26

⁵ ISA (NZ) 570, Paragraph 18(a)

- A description of the entity's plans for dealing with these events or conditions.⁶

Disclosure of material uncertainties related to events or conditions that might cast significant doubt on the entity's ability to continue as a going concern.⁷

- A statement to the effect that "If the going concern assumption is not valid, the consequence is the entity may be unable to realise the value in its assets and discharge its liabilities in the normal course of business".⁸

Significantly, in 79 percent of cases, the financial statements in our sample did not meet the mandatory disclosure requirements in the audit standard ISA (NZ) 570 *Going Concern*. In those cases where disclosures don't comply with the standard, this indicates that:

- directors do not believe a material uncertainty exists and see no need to make the disclosures in which case an EoM may not be appropriate, or
- directors are potentially not meeting their disclosure obligations to investors and / or
- the auditors are using the EoM paragraph inappropriately without completing the necessary audit testing to support the use of the EoM paragraph.

Of the audit opinions considered, our review identified the following concerns:

- Inadequate communication of the material uncertainty required to support the use of the EoM paragraph in relation to the going concern assumption⁹.
- Cases where greater audit testing would appear likely to have resolved instances of going concern uncertainty. Good examples would be circumstances where ongoing shareholder or bank financial support are a necessary condition for the going concern assumption and satisfactory audit testing would be expected to identify whether the assumption of ongoing support is credible or not.
- Use of the EoM going concern paragraph for entities that have had a business set back, but for which uncertainty has not yet been demonstrated to be material.
- Disclosures that contradicted the going concern assumption. For example, auditors accepting the going concern assumption for entities that have stated in their financial statements that their intention is to sell their operating assets, cease their main business activities or wind up the business.
- Instances where the EoM paragraph raised issues not disclosed in the financial statements themselves. An EoM paragraph cannot introduce new material which is not already disclosed in the financial statements.
- Instances where it appears that a qualified opinion or an adverse opinion would be more appropriate because the entity's disclosures did not meet the accounting or audit standard requirements to support the going concern assumption.

⁶ ISA (NZ) 570, Paragraph 18(a)

⁷ ISA (NZ) 570, Paragraph 18(b)

⁸ ISA (NZ) 570, Paragraph 18(b)

⁹ As required by ISA (NZ) 570, Paragraph 19

Audit report compliance with the key requirements of the audit standard

A number of audit reports reviewed used the EoM paragraph disclosure but did not comply with the technical requirements in relation to placement of the EoM paragraph or specific wording required. To ensure clarity and avoid misinterpretation by the reader it is important to apply the standard precisely.

As an example, a significant omission in a number of audit reports was the absence of the disclosure¹⁰ in the EoM paragraph that the auditor's opinion "is not qualified in respect of this matter". The absence of the required wording creates the potential for misunderstanding.

Financial statements disclosure by issuers

Some of the issues that FMA identified in the disclosures for going concern in the financial statements were as follows:

- A statement that the directors' view that the going concern basis was appropriate, without identifying the assumptions the directors had made in reaching that conclusion.
- General assertions of the directors' opinions as to going concern without any supporting commentary to provide evidence to the reader that the directors' opinions were based on credible business planning that had carefully considered the risks involved.
- Providing a list of events without elaborating on how they specifically related to the going concern assumption.
- Stating there were uncertainties, but not providing information as to what these were.
- Suggested solutions in the disclosures to support the going concern assumption without sufficient explanation to indicate that the directors had considered whether the solutions proposed were practically achievable.
- Providing a list of options under consideration without quantifying or prioritising those to illustrate their effect on reducing the going concern risk to the entity.

Conclusion

In many cases the financial reporting of going concern in issuer financial statements did not give enough factual information to enable investors to understand the particular risks and uncertainties that impact on the going concern assumption.

Of particular concern is that many of the audits of these entities are not compliant with the audit standard that relates to the certification of going concern issues in financial statements. If auditors are not complying with key requirements of the auditing standard they are at risk of issuing an incorrect opinion and investors may be misled.

¹⁰ Required by ISA (NZ) 706, Paragraph 7(d)



FMA's expectations

We expect to see substantial improvements in future disclosures of going concern by issuers to address the inadequacies identified in this report. Disclosure of key aspects of the going concern assumption, such as the principal events or conditions that give rise to going concern risk when they occur, the material uncertainty related to those events or conditions, and the plans in place to address those uncertainties must be improved.

FMA expects the auditors of issuers to address the observed shortcomings in audit reports with respect to going concern disclosures, to ensure that their performance in relation to the matters identified in this report is substantially improved.

We will continue to monitor both the going concern disclosures of financial statements and annual reports, and the auditor's performance regarding the application of the audit standards relating to going concern¹¹.

¹¹ Auditor oversight plan 2013-2016

