SA 570 (AAS 16)

GOING CONCERN

(Effective for all audits relating to accounting periods beginning on or after April 1, 1999)

Contents

Standard on Auditing (SA) 570[*], "Going Concern" should be read in the context of the "Preface to the Standards on Quality Control, Auditing, Review, Other Assurance and Related Services"[1], which sets out the authority of SAs.

[*] Issued in October, 1998.

[1] Published in the July 2007 issue of the Journal.

Introduction

1. The purpose of this Standard on Auditing (SA) is to establish standards on the auditor's responsibilities in the audit of financial statements regarding the appropriateness of the going concern assumption as a basis for the preparation of the financial statements.

2. When planning and performing audit procedures and in evaluating the results thereof, the auditor should consider the appropriateness of the going concern assumption underlying the preparation of the financial statements.

3. The auditor's report helps establish the credibility of the financial statements. However, the auditor's report is not a guarantee as to the future viability of the entity.

4. An entity's continuance as a going concern for the foreseeable future, generally a period not to exceed one year after the balance sheet date, is assumed in the preparation of financial statements in the absence of information to the contrary. Accordingly, assets and liabilities are recorded on the basis that the entity will be able to realise its assets and discharge its liabilities in the normal course of business. If this assumption is unjustified, the entity may not be able to realize its assets at the recorded amounts and there may be changes in the amounts and maturity dates of liabilities. As a consequence, the amounts and classification of assets and liabilities in the financial statements may need to be adjusted.

Appropriateness of the Going Concern Assumption

5. The auditor should consider the risk that the going concern assumption may no longer be appropriate.

6. Indications of risk that continuance as a going concern may be questionable could come from the financial statements or from other sources. Examples of such indications that would be considered by the auditor are listed below. This listing is not all-inclusive nor does the existence of one or more always signify that the going concern assumption needs to be questioned.

Financial Indications

- Negative net worth or negative working capital.

- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment, or excessive reliance on short-term borrowings to finance long-term assets.
- Adverse key financial ratios.
- Substantial operating losses.
- Substantial negative cash flows from operations.
- Arrears or discontinuance of dividends.
- Inability to pay creditors on due dates.
- Difficulty in complying with the terms of loan agreements.
- Change from credit to cash-on-delivery transactions with suppliers.
- Inability to obtain financing for essential new product development or other essential investments.
- Entering into a scheme of arrangement with creditors for reduction of liability.

Operating Indications

- Loss of key management without replacement.
- Loss of a major market, franchise, licence, or principal supplier.
- Labour difficulties or shortages of important supplies.

Other Indications

- Non-compliance with capital or other statutory requirements.
- Pending legal proceedings against the entity that may, if successful, result in judgments that could not be met.
- Changes in legislation or government policy.
- Sickness of the entity under any statutory definition.

7. The significance of such indications can often be mitigated by other factors. For example, the effect of an entity being unable to make its normal debt repayments may be counterbalanced by management's plans to maintain adequate cash flows by alternative means, such as by disposal of assets, rescheduling of loan repayments, obtaining additional capital or

having funding arrangements backed by government. Similarly, the loss of a principal supplier may be mitigated by the availability of a suitable alternative source of supply.

Audit Evidence

8. When a question arises regarding the appropriateness of the going concern assumption, the auditor should gather sufficient appropriate audit evidence to attempt to resolve, to the auditor's satisfaction, the question regarding the entity's ability to continue in operation for the foreseeable future.

9. During the course of the audit, the auditor carries out audit procedures designed to obtain audit evidence as the basis for the expression of an opinion on the financial statements. When a question arises regarding the going concern assumption, certain of these procedures may take on additional significance or it may be necessary to perform additional procedures or to update information obtained earlier. Procedures that are relevant in this connection may include:

- Analyse and discuss cash flow, profit and other relevant forecasts with management.
- Review events after the balance sheet date for items affecting the entity's ability to continue as a going concern.
- Analyse and discuss the entity's latest available interim financial statements.
- Review the terms of debentures and loan agreements and determine whether any have been breached.
- Read minutes of the meetings of shareholders, the board of directors and important committees for reference to financing difficulties.
- Review the status of matters under litigation and claims.
- Confirm the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties and assess the financial ability of such parties to provide additional funds.
- Consider the entity's position concerning unfilled customer orders.

10. When analysing cash flow, profit and other relevant forecasts, the

auditor would consider the reliability of the entity's system for generating such information. The auditor would also consider whether the assumptions underlying the forecast appear appropriate in the circumstances. In addition, the auditor would compare the prospective data for recent prior periods with historical results, and would compare the prospective data for the current period with results achieved to date.

11. The auditor would also consider and discuss with management its plans for future action, such as plans to liquidate assets, borrow money or restructure debt, reduce or delay expenditure, or increase capital. The relevance of such plans to an auditor generally decreases as the time period for planned actions and anticipated events increases. Particular emphasis is ordinarily placed on plans that might have a significant effect on the entity's solvency within the foreseeable future. The auditor would obtain sufficient appropriate audit evidence that these plans are feasible, are likely to be implemented and that the outcome of these plans will improve the situation. The auditor would ordinarily seek written representations from management regarding these plans.

Audit Conclusions and Reporting

12. After the procedures considered necessary have been carried out, all the information required has been obtained, and the effect of any plans of management and other mitigating factors have been considered, the auditor would decide whether the question raised regarding the going concern assumption has been satisfactorily resolved.

Going Concern Assumption Considered Appropriate

13. If, in the auditor's judgement, sufficient appropriate audit evidence has been obtained to support the going concern assumption, the auditor would not qualify his report on this account.

14. If, in the auditor's judgement, the going concern assumption is appropriate because of mitigating factors, in particular management's plans for future action, the auditor should consider whether such plans or other factors need to be disclosed in the financial statements. Where the auditor concludes that such plans or other factors need to be disclosed, but have not been adequately disclosed, the auditor should express a qualified or adverse opinion, as appropriate.

Going Concern Question not Resolved

15. If, in the auditor's judgement, the going concern question is not satisfactorily resolved, the auditor would consider whether the financial statements:

(a) adequately describe the principal conditions that raise substantial doubt about the entity's ability to continue in operation for the foreseeable future;

(b) state that there is significant uncertainty that the entity will be able to continue as a going concern and, therefore, may be unable to realise its assets and discharge its liabilities in the normal course of business; and

(c) state that the financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts, or to amounts and classification of liabilities that may be necessary if the entity is unable to continue as a going concern.

Provided the disclosure is considered adequate, the auditor would not express a qualified or adverse opinion.

16. If adequate disclosure is made in the financial statements, the auditor should ordinarily express an unqualified opinion. However, he should, in his report, add a paragraph that highlights the going concern problem by drawing attention to the note in the financial statements that discloses the matters set out in paragraph 15. The following is an example of such a paragraph:

> "We draw attention to Note X in the financial statements. The Company incurred a net loss of Rs. XXX during the year ended March 31, 19X1 and, as of that date, the Company's current liabilities exceeded its current assets by Rs. XXX and its total liabilities exceeded its total assets by Rs. XXX. These factors, along with other matters as set forth in Note X, raise substantial doubt that the Company will be able to continue as a going concern."

The auditor is not precluded from expressing a disclaimer of opinion for a going concern uncertainty.

17. If adequate disclosure is not made in the financial statements, the auditor should express a qualified or adverse opinion, as appropriate.

The following is an example of the explanation and opinion paragraphs when a qualified opinion is to be expressed:

> "The Company has been unable to renegotiate its borrowings from its bankers. Without such financial support there is substantial doubt that it will be able to continue as a going concern. Consequently, adjustments may be required to the recorded asset amounts and classification of liabilities. The financial statements (and notes thereto) do not disclose this fact.
>
> In our opinion, subject to the omission of the information dealt with in the preceding paragraph, the financial statements give a true and fair view of the financial position of the Company at March 31, 19X1 and the results of its operations for the year then ended."

Going Concern Assumption Considered Inappropriate

18. If, on the basis of the additional procedures carried out and the information obtained, including the effect of mitigating circumstances, the auditor's judgment is that the entity will not be able to continue in operation for the foreseeable future, the auditor would conclude that the going concern assumption used in the preparation of the financial statements is inappropriate. If the result of the inappropriate assumption used in the preparation of the financial statements is so material and pervasive as to make the financial statements misleading, the auditor should express an adverse opinion.

Effective Date

19. This Standard on Auditing becomes operative for all audits relating to accounting periods beginning on or after April 1, 1999.

GENERAL CLARIFICATION (GC)–AASB/3/2004 ON SA 570

Standard on Auditing (SA) 570, "Going Concern"

{The following is the General Clarification (GC)–AASB/3/2004 issued by the Auditing and Assurance Standards Board of the Institute of Chartered Accountants of India on Standard on Auditing (SA) 570, "Going Concern".}

1. The Companies (Amendment) Act, 2000 has mandated that every private company existing on 13th December 2000 with a paid-up capital of less than one lakh rupees, shall, within a period of two years from such commencement enhance its paid up capital to one lakh rupees. Similarly, every public company existing on 13th December 2000 with a paid-up capital of less than five lakh rupees, shall, within a period of two years from such commencement enhance its paid up capital to five lakh rupees. Where a private company or a public company fails to enhance the paid-up capital to the statutory minimum, as mentioned above, such company shall be deemed a defunct company within the meaning of section 560 of the Companies Act, 1956 and its name shall be struck off from the register by the Registrar.

2. Paragraphs 5 and 6 of Standard on Auditing (SA) 570, "Going Concern" provide as follows:

> "5. The auditor should consider the risk that the going concern assumption may no longer be appropriate.
>
> 6. Indications of risk that continuance as a going concern may be questionable could come from the financial statements or from other sources."

3. Further, SA 570 also mentions that non-compliance with capital or other statutory requirements could be an example of an indication of risk that the going concern assumption may no longer be appropriate.

4. If a company fails to enhance its paid-up capital up to the statutory minimum, such company shall be deemed a defunct company within the meaning of section 560 of the Companies Act, 1956 and therefore, its name shall be struck off from the register by the Registrar of Companies. However,

such an entity may decide not to carry on business or may decide to carry on the business in some other form of organisation, e.g., partnership, etc. This situation gives rise to the risk that the going concern assumption may no longer be appropriate.

5. The auditor, in such a situation, performs the audit procedures as required by the Standard on Auditing (SA) 570, “Going Concern”. Unless, the entity under audit demonstrates otherwise, the auditor should consider the going concern assumption as inappropriate and report in accordance with paragraph 18 of SA 570.