Chapter 1

Analysing the going concern assumption under the COVID-19 scenario

This article aims to:

Discuss the key aspects relating to going concern assessment.

Introduction

Going concern is one of the fundamental principles of accounting, on the basis of which financial statements are prepared. Under this principle, it is assumed that a business will continue to operate in the foreseeable future[1] without the need or intention to liquidate or curtail its operational activities. Accordingly, the 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.

It is the responsibility of the management of an entity to determine whether the going concern assumption is appropriate in the preparation of financial statements. Implementation of stringent measures to contain or delay the spread of COVID-19 has significantly disrupted business operations and economic activity. The unpredictability of the potential impact of the outbreak may result in material uncertainties that cast doubt on an entity's ability to operate as a going concern. It is therefore important for the management to understand and anticipate the effects of COVID -19 on their business while performing an assessment of going concern this year.

1. A minimum of 12 months from the end of the reporting period as per Ind AS 1, *Presentation of Financial Statements*.
2. As per the requirement of Ind AS 1.
3. Liquidity risk is the risk that a company will be unable to meet its liabilities as they fall due.
4. Solvency risk is the risk that a company will be unable to meet its liabilities in full. Over the long term a company must generate sufficient value such that its assets exceed its liabilities. A failure to do so could render it insolvent. Insolvency is likely to be preceded by a lack of liquidity.

The article aims to cover the following aspects pertaining to going concern assessment:

- **Management's assessment of going concern under COVID-19**
- **Disclosure requirements**
- **Auditor's responsibility**
- **Impact on auditor's report**
- **Communication with those charged with governance**

Management's assessment of going concern under COVID-19

Certain sectors may face financial distress, such as declining demand, falling sales and margin pressures and could be more exposed than others. In this scenario, the risk assessment procedures of going concern performed by management would be very different to that from previous years. An overall lower economic activity in the country has created an unprecedented level of uncertainty of consequent future earnings of entities, particularly in the near term. In this highly uncertain environment, management's going concern assessments would be more difficult to be made. Therefore, management may consider to undertake following steps:

- Identify the principal risks and uncertainties to its business[2] caused by the pandemic, this majorly includes the entity's liquidity[3] and solvency[4] risks.
- Revise budgets as the budgets prepared for financial year 2019-20 may be of limited relevance
- Update forecasts (e.g. forecast sales, gross margins and changes in working capital) taking into account risk factors identified and different possible outcomes
- Reassess sources of finance e.g. from external lenders or related parties
- Undertake a review of projected covenant compliance in different scenarios
- Reconsider the feasibility of management's plans for future actions such as refinancing of existing debts and restructuring of operations.

While updating the budgets, all relevant information available upto the date the financial statements are authorised for issue should be considered. A downside scenario analysis should also be performed. Additionally, all available information about the future for at least, but not limited to, 12 months from the reporting date should be considered.

Disclosure requirements

The financial statements should disclose sufficiently relevant and entity-specific information with regard to the effect of the lockdown restrictions on their businesses in different short-term scenarios. These disclosures should describe following:

- Significant judgements and estimates made by management
- The manner in which liquidity risk has been managed in this difficult economic situation
- Any default or breach relating to borrowing recognised during and at the end of the reporting period
- Disclosure of key sources of estimation uncertainty about the carrying amounts of assets and liabilities
- Disclosure of objectives, policies and procedures for managing capital, including regulatory capital
- Disclosures regarding timing and amount of provisions and contingencies.

Auditor's responsibility on going concern assessment under COVID-19

Auditors would evaluate and conclude on the appropriateness of management's use of the going concern basis of accounting in the preparation of financial statements, and would need to conclude whether a material uncertainty related to the entity's ability to continue as a going concern exists.

An auditor would undertake this assessment by performing additional audit procedures and exercise professional skepticism while evaluating management's going concern assessment and the feasibility of their plans for future actions.

Auditors would also evaluate the adequacy of the disclosures, including whether information related to the going concern assessment is complete, accurate and includes the information necessary to achieve the fair presentation of the financial statements as a whole.

Impact on the auditor's report

These challenges could lead to certain implications in the auditor's report which may include:

- Reporting of a new Key Audit Matter (KAM) in response to additional audit work necessary as a result of the outbreak of COVID-19
- Addition of a material uncertainty in relation to going concern paragraph, where relevant
- An emphasis of matter paragraph relating to a significant uncertainty arising from the outbreak
- A qualification or adverse opinion in respect of inadequate disclosures in the financial statements.

Communication with those charged with governance

With circumstances changing rapidly due to COVID-19, the going concern assessment becomes an important and challenging assessment for the management, those charged with governance and the auditors. In this scenario, it is vital that those charged with governance are subsumed on this matter.

Where auditors identify events or conditions that may cast significant doubt on the entity's ability to continue as a going concern, they would communicate with those charged with governance the following:

- Whether the events or conditions constitute a material uncertainty
- Whether management's use of going concern basis of accounting is appropriate in the preparation of the financial statements
- The adequacy of the disclosures in the financial statements and
- Where applicable, the implications for the auditor's report.

Any unwillingness on the part of the management to make or extend its assessment of the entity's ability to continue as a going concern should also be communicated.

Way forward

Given the intricacies involved in the constantly evolving situation of COVID-19 and the significant judgements and estimates that would be required to determine the potential impacts, management and those charged with governance must remain watchful to ensure this area remains a high priority.

Accordingly, companies should take adequate time to finalise their year-end reporting and assess the impact of the current events on their liquidity and solvency risks. As more information is available to companies, it is likely to enable them to make judgements and estimates with regard to going concern and other aspects of the financial reporting.