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Going Concern & Materiality

Chartered Accountancy
Strategic Level
Advanced Business Reporting (ABR)

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GOING CONCERN & MATERIALITY

SLAuS 570 (Revised)

Going concern

Under the going concern basis of accounting, the financial statements are prepared on the assumption that the entity is a going concern and will continue its operations for the foreseeable future.

Going concern

- When the use of the going concern assumption is appropriate, 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.
- The financial statements should be prepared on the going concern basis unless management either intends to liquidate the entity or has no realistic alternative but to do so.
- ***If the going concern basis is not appropriate, the financial statements are prepared on another basis, such as the liquidation basis.***

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SOFP

Source of Fund	Uses of Funds
Share capital from owners	NCA
100 + (-50) = Equity (NA) +50	
NCL - lenders	CA
CL - Creditors	

Auditor is responsible to assess the APPROPIATENESS of GC Assumption

We will utilize assets & generates profits to repay the amount borrowed and its return (Normal Course of Business)
If no GC, entity will dispose their assets to settle liabilities.

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The objectives of the auditor are:

- To obtain sufficient appropriate audit evidence regarding, and conclude on, the **appropriateness** of management's use of the going concern basis of accounting in the preparation of the financial statements;

- To conclude, based on the evidence obtained, whether a **material uncertainty** exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern; and

- To determine the **implications** for the auditor's report SLAuS 570 includes examples of events or conditions that may cast doubt about the going concern assumption.

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Financial

- Net liability or net current liability position (Total Asset –Liability = -Net Asset)
- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment
- Indications of withdrawal of financial support by creditors
- Negative operating cash flows (historical or prospective)
- Adverse key financial ratios
- Substantial operating losses or significant deterioration in the value of assets used to generate cash flows
- Arrears or discontinuance of dividends
- Inability to pay creditors on due dates
- Inability to comply with 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

Operating

- ❖ Management intentions to liquidate or cease operations
- ❖ Loss of key management without replacement
- ❖ Loss of a major market, key customers, licence, or principal suppliers
- ❖ Labour difficulties
- ❖ Shortages of important supplies
- ❖ Emergence of a highly successful competitor.

Other

- ❖ Non-compliance with capital or other statutory requirements
- ❖ Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy
- ❖ Changes in laws/regulations/government policy expected to adversely affect the entity
- ❖ Uninsured or underinsured catastrophes when they occur

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- ✓ The auditor must **remain alert** throughout the audit for evidence of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.
- ✓ However, the auditor also has specific responsibilities in relation to management's assessment.
- ✓ The auditor shall **evaluate** management's assessment of the entity's ability to continue as a going concern.
- ✓ However, if this assessment covers less than 12 months from the date of the financial statements, the auditor shall ask management to extend its assessment period to **at least 12 months** from that date.
- ✓ The auditor shall also enquire of management its knowledge of events or conditions beyond the period of the assessment that may cast significant doubt on the entity's ability to continue as a going concern.

Auditor's responsibilities in relation to management's assessment

Audit procedures applied in performing going concern reviews

- ✓ **Analyse and discuss cash flow**, profit and other relevant forecasts with management
- ✓ **Analyse and discuss** the entity's latest available **interim financial statements** (or management accounts)
- ✓ **Review the terms of debentures and loan agreements** and determine whether they have been breached
- ✓ **Read minutes** of the meetings of shareholders, the board of directors and important committees for reference to financing difficulties
- ✓ **Enquire** of the entity's lawyer regarding **litigation and claims**
- ✓ **Confirm the existence, legality and enforceability** of arrangements to provide or maintain financial support with related and third parties
- ✓ **Assess** the **financial ability** of such parties to **provide additional funds**
- ✓ **Consider the entity's position** concerning unfulfilled customer orders
- ✓ **Review events after the period-end** for items affecting the entity's ability to continue as a going concern
- ✓ Confirm the existence, terms and **adequacy of borrowing facilities**
- ✓ Obtaining and **reviewing reports of regulatory actions**
- ✓ Determining the **adequacy of support for any planned disposals** of assets

Auditor reporting

1. **<u>Going concern assumption appropriate</u>** ***<u>but</u>*** <u>material uncertainty which is adequately disclosed</u>

<u>Unmodified opinion</u>

Emphasis of matter - Section headed 'Material Uncertainty Related to Going Concern'

2. Going concern assumption appropriate but material uncertainty which is not adequately disclosed

Qualified or adverse opinion (ie modified opinion)

3. Use of going concern assumption inappropriate

Adverse opinion (ie modified opinion)

4. Management unwilling to make or extend its assessment

Qualified or disclaimer of opinion (ie modified opinion)

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Materiality

Materiality for the financial statements as a whole and performance materiality must be calculated at the planning stages of all audits. The calculation or estimation of materiality should be based on experience and judgement. Materiality for the financial statements as a whole must be reviewed throughout the audit and revised if necessary.

Value	%
Profit before tax	5 – 10
Gross profit	½ – 1
Revenue	½ – 1
Total assets	1 – 2
Net assets	2 – 5
Profit after tax	5 – 10

	PI entities	Non-PI entities
Manufacturing & Services **NPAT/ NPBT**	5% or above	10% or above
Trading Business **Sales/ Revenue**	0.5% or above	1% or above

***Performance materiality* is the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole.**

***Performance materiality* also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures**

How to determine Planning materiality ……… ?
Relationship between ML & AR
– ~~positive~~ or negative

	Public Interest Entities Eg. PLC / banks / Insu/ Leasing / Finance/ FD/ MB/ UT ect *(2nd para of SLFRS for SME)*	**Non-Public Interest Entities** *Auditor can tolerate more since risk is relative low*
Manufacturing & Service Companies BASE : PAT or PBT	5%	10%
Retail business Eg. Keels/ Cargils / Glowmark/ Laughs/ SPAR BASE: Revenue	0.5%	1%

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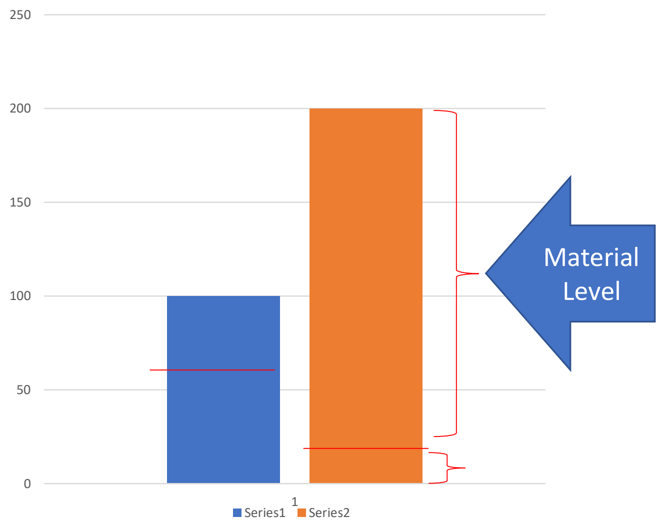
Identify the relationship between Material level & Audit Risk



There is a **Negative relationship**

When Material level increasing audit risk will also decrease due to decrease of tolerated area

Set the planning material level for following audit clients

ABC PLC is a company engages in a retail outlets around the country – net profit 100mn, revenue 1200mn (0.5% x 1200)

X PLC is an Insurance company – net profit 1100mn, revenue 7500mn

(5% x 1100)

Y (Pvt) Ltd is a manufacturer of tires – net profit 450mn, revenue 11200mn

(10% x 450)

R PLC is manufacturer – net profit (1100)Mn, revenue 7500mn (0.5% x 7500)

Q is a private company engages in a private school – net profit 1100mn, revenue 7500mn (10% x 1100)

Problems with materiality

As discussed above, materiality is a matter of judgement. Therefore, prescriptive rules will not always be helpful when assessing materiality. A **significant risk** of prescriptive rules is that a **significant matter**, which **falls outside the boundaries of the rules**, could be overlooked, leading to a **material misstatement in the financial statements**.

- In some companies, **post tax profit** is the key figure in the financial statements, as the level of dividend is the most important factor in the accounts.
- In **owner managed businesses**, if owners are paid a salary and are indifferent to dividends, the key profit figure stands higher in the statement of profit or loss, say at **gross profit** level. Alternatively, in this situation, the auditor should consider a figure that does not appear in the statement of profit or loss: **profit before directors' salaries and benefits**.
- Some companies are **driven by assets** rather than the need for profits. In such examples, higher materiality might need to be applied to assets. In some companies, say charities, **costs** are the driving factor, and materiality might beconsidered in relation to these.
- While rules or guidelines are helpful to auditors when assessing materiality, they must always keep in mind the **nature** of the business they are dealing with.
- Materiality must be **tailored to the business and the anticipated user** of financial statements, or it is not truly materiality. Refer back to the definition of materiality and consider **all the elements** of it.

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