GOING CONCERN ISSUES IN FINANCIAL REPORTING:
A GUIDE FOR COMPANIES AND DIRECTORS

Australian Government
Auditing and Assurance Standards Board

AUSTRALIAN INSTITUTE OF COMPANY DIRECTORS

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Going Concern issues in financial reporting:

a guide for companies and directors

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AICD

The Australian Institute of Company Directors (AICD) is a member institute for directors dedicated to having a positive influence on the economy and society by promoting professional directorship and good governance. AICD delivers education, information and advocacy to enrich the capabilities of directors, influence the corporate governance environment in Australia and promote understanding of and respect for the role of directors. With offices in each state and more than 24 000 members, AICD represents a diverse range of organisations, from the top 200 publicly-listed companies to not-for-profits, public sector entities and smaller private family concerns.

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The Auditing and Assurance Standards Board (AUASB) is an independent, statutory agency of the Australian Government, responsible for developing, issuing and maintaining auditing and assurance standards. The mission of the AUASB is to develop, in the public interest, high-quality auditing and assurance standards and related guidance, as a means to enhance the relevance, reliability and timeliness of information provided to users of auditing and assurance services. Australian Auditing Standards issued by the AUASB are legally enforceable for audits or reviews of financial reports required by, or in accordance with the *Corporations Act 2001*.

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Executive summary

This publication has been developed in an environment when Australian companies and other entities are experiencing the impact of difficult or uncertain economic conditions in varying degrees. The effects of such economic conditions may be significant in the area of financial reporting, in particular, the directors' assessment of their company's ability to continue as a going concern. This publication explains the concept of "going concern" and aims to assist company directors in performing, and reporting on, their going concern assessment.

Going concern is a basic business concept which is also a fundamental principle underlying the preparation of the vast majority of annual reports, and in particular, the financial reports[1], of Australian companies. Australian Accounting Standards require directors to consider whether there are material uncertainties that would lead to significant doubt about a company's ability to continue to pay its debts over at least the next 12 months and to make adequate disclosures in the financial report if such uncertainties are identified. The company's auditors are required by Australian Auditing Standards to evaluate the directors' assessment of the company's ability to continue as a going concern within the "relevant period".[2]

1. A financial report comprises the complete set of financial statements including comparative information (statement of financial position, statement of comprehensive income, statement of changes in equity, statement of cash flows, notes to the financial statements) and the directors' declaration. A financial report is part of an annual report. Refer to Accounting Standard AASB 101 (Revised September 2007), paragraph 10, for the definition of complete set of financial statements.
2. See Compiled Auditing Standard ASA 570 *Going Concern*, paragraphs 7, 22 and 23.

Difficult or uncertain economic conditions, as they relate to going concern, present challenges for:

- Company directors (directors)—particularly those of listed companies, who will need to ensure that they prepare thoroughly for their assessment of going concern and make appropriate financial report disclosures
- Independent Auditors (auditors)—who will need to ensure that they adequately evaluate directors' going concern assessments and only refer to going concern in their audit opinions when appropriate
- Users of financial reports—who will need to carefully consider the potential implications of these conditions in market announcements and financial reports. Such users include the investment community, finance lenders, suppliers, customers and employees.

In view of the above, this publication includes a discussion of:

- The going concern assumption—what it means and its context in difficult or uncertain economic conditions
- Going concern and liquidity risk—in particular, disclosure requirements
- The company's interaction with the auditor—the directors' role in planning for the audit and the types of audit opinions that may result from uncertainties about the going concern assumption for a company
- Communications issues—including continuous disclosure obligations of listed companies.

There is some history of shareholders and the business media confusing the concepts of "insolvency" and "going concern". Similarly, the distinctions between an "unqualified opinion containing an emphasis of matter" paragraph, a "qualified" audit opinion and a "disclaimer" of audit opinion are not always well understood by some readers of financial reports. This publication addresses the confusion over the concepts of "insolvency" and "going concern" by including an overview of relevant insolvency law to explain what constitutes "insolvency", in addition to an explanation of the "going concern" concept. It also explains the nature and range of possible auditor's opinions relating to going concern issues, to enable directors to be better informed of the audit implications of going concern issues.

This publication also contains helpful appendices that include:

- a checklist of possible events and conditions that may affect the going concern assessment
- a checklist of risk factors to consider in the preparation of financial reports during challenging or uncertain economic conditions
- examples of going concern and solvency disclosures in the *Directors' Report*
- summary of the circumstances in which each type of audit opinion may be reached by the auditor, depending on the directors' going concern assessment and disclosures
- a flowchart showing how the auditor's going concern considerations are linked to the various types of audit opinions
- a summary of Australian laws and regulations relating to going concern.

This publication provides guidance specifically aimed at for-profit companies (particularly those that are listed on the Australian Securities Exchange (ASX)) and their directors. It may also be useful for directors of unlisted and other companies, other disclosing entities, and non-corporate entities (for example, not-for-profits) with similar reporting and/or regulatory responsibilities related to going concern. This publication may also provide useful information for readers and users of annual reports, for example, investors and the business media.

The term "directors" is used throughout this publication to refer to those persons who are charged with the governance responsibilities of a company (collectively "the board of directors" or their equivalent). It is acknowledged that in some companies, some of the directors' responsibilities may be performed by management or the audit committee, and consequently, the term is taken to include management and/or the audit committee where appropriate.

Certain requirements and guidance found in the *Corporations Act 2001*, *ASX Listing Rules*, *Australian Auditing Standards*, and *Australian Accounting Standards* are highlighted, but they are not meant to be exhaustive. This publication does not establish or extend any new requirements in the area of going concern.

The Auditing and Assurance Standards Board (AUASB) Bulletin *Auditing Considerations in an Uncertain Economic Environment* (April 2009) may be helpful to directors to better understand auditors' considerations and reporting responsibilities in relation to the financial report audit especially when conducting the audit in times of uncertain or difficult economic conditions. The Bulletin highlights various auditing considerations relating to going concern and other financial reporting matters that are relevant in such economic conditions.

Going concern—what it means and its context in difficult or uncertain economic conditions

Key points:

- ➢ The going concern assumption is a fundamental principle that underlies the preparation of the vast majority of financial reports (incorporated in the annual reports) of Australian companies.
- ➢ A company is a going concern when it is considered to be able to pay its debts as and when they are due, *and* continue in operation without any intention or necessity to liquidate or otherwise wind up its operations for at least the next 12 months.

Introduction

The vast majority of financial reports (included in the annual reports) of Australian companies are prepared on the assumption that a company is a going concern. If a company is not a going concern, and its financial report is prepared based on an alternative authoritative basis (for example, liquidation basis), then the auditor is required to determine whether such a basis of preparation is appropriate.[3]

This publication has been developed on the basis that the company's financial report has been prepared on a going concern basis. Under Australian Accounting Standards[4] and the *Corporations Act 2001*, directors are required to satisfy themselves that it is reasonable for them to conclude that it is appropriate to prepare the financial report on a going concern basis. These requirements are not intended to, and do not, guarantee that a company will remain a going concern until the next financial report (and annual report) is issued.

3. See Compiled Auditing Standard ASA 570, paragraph 45
4. See Australian Accounting Standard AASB 101 *Presentation of Financial Statements*, (Revised September 2007) paragraph 25

A company (whether for-profit or not-for-profit) is a going concern when it is considered to be able to pay its debts as and when they are due, and continue in operation without any intention or necessity to liquidate or otherwise wind up its operations for at least the next 12 months from the end of the reporting period (that is, financial year end).

Directors (or their equivalent in the case of not-for-profit entities) are required to assess a company's ability to continue as a going concern each time the financial report is approved for issuance. In the case of companies subject to the *Corporations Act 2001*, this assessment is performed annually, with half-yearly assessments being additional for listed companies.

In contrast auditors are required by Australian Auditing Standards to evaluate the directors' assessment of a company's ability to continue as a going concern for a period of approximately 12 months from the date of the auditor's most recent report to the expected date of the auditor's report for the next reporting period.[5] If the directors' assessment period is shorter than that of the auditor, the auditor is required by Australian Auditing Standards to ask the directors to extend their assessment period to correspond to the auditor's assessment period.[6]

Uncertain or difficult economic conditions provide particular challenges for those involved in the preparation of annual reports, in particular, year-end financial reports. One consequence is expected to be an increase in the disclosures in the financial report (incorporated in the annual report) about the company's going concern assessment and liquidity risk (see *The directors' going concern assessment and liquidity risk disclosures*

5. As indicated in Compiled Auditing Standard ASA 570, paragraph 7, the next reporting period means "the next annual reporting period in the case of an annual financial report; or, the corresponding reporting period for the following year in the case of an interim reporting period."
6. See Compiled Auditing Standard ASA 570, paragraph 23

discussion on page 17). For example, challenging economic conditions may lead to greater than usual uncertainty about:

- bank lending intentions and the availability of finance more generally
- the impact of such economic conditions on a company's cash flow position
- the impact of such economic conditions on a company's own business
- the impact of such economic conditions on third parties with whom the company conducts business, including customers and suppliers.

It is important for directors and auditors to discuss at the earliest possible opportunity in the audit process any issues that could or do impact the company's going concern assessment. The AUASB Bulletin *Auditing Considerations in an Uncertain Economic Environment* (April 2009) includes relevant discussion on this matter. Following is an overview of directors' obligations concerning their going concern assessment, in the context of difficult or uncertain economic conditions. Related disclosures concerning liquidity risk and insolvency are also explained.

The directors' going concern assessment and liquidity risk disclosures

Key points:

- ➢ Directors will need to plan their assessment of going concern as early as practicable and have early discussions with their finance providers and auditor about their plans.
- ➢ Difficult or uncertain economic conditions may give rise to a number of possible events and conditions that may affect the going concern assessment.
- ➢ The significance of identified events and conditions will vary from company to company, but may be mitigated by other factors.
- ➢ The going concern assessment and the preparation of liquidity risk disclosures in the financial report are interrelated.

Overview of requirements for going concern assessment by directors

Accounting Standard AASB 101 *Presentation of Financial Statements* requires directors when preparing the financial report to:

- make an assessment of a company's ability to continue as a going concern
- disclose the uncertainties about which the directors were aware in making their assessment of going concern where those uncertainties may cast significant doubt on the company's ability to continue as a going concern.

A detailed analysis supporting a company's going concern status may not be required if the company has a history of profitable operations; there is little concern about it continuing to be profitable; and it has ready access to required financial resources.

However, in a difficult or uncertain economic environment it may become harder to support the going concern assumption without performing such a detailed analysis. Directors should always consider the appropriateness of the company's going concern assessment at financial reporting end.

Directors should always satisfy themselves that management have adequate supporting documentation that is able to support the going concern assessment and assumption. Where management prepares a detailed analysis it should include their reassessment of the extent to which their past forecasts (for example, cash flows) and underlying assumptions have been accurate when compared to actual financial results. Factors to consider in this evaluation include:

- the degree of uncertainty about a future event or condition will increase as the length of the period increases, until that event or condition is expected to occur
- an assumption that was made in the last going concern assessment may not remain valid for the current assessment
- larger and more complex companies as well as those paticularly sensitive to external factors will require significantly more judgments about the outcomes of future events and conditions.

The effects of difficult or uncertain market conditions on an individual company require careful evaluation. A difficult or uncertain economic environment in which the company operates does not of itself necessarily mean that there are uncertainties that may cast significant doubt about a company's ability to continue as a going concern.

In forming their final assessment of going concern directors will need to evaluate which of the following potential outcomes is appropriate to their specific company circumstances:

- there are no material uncertainties that lead to significant doubt about the company's ability to continue as a going concern
- there are material uncertainties that lead to significant doubt about the company's ability to continue as a going concern or
- the use of the going concern basis is not appropriate.

The going concern assessment is likely to include a high degree of judgment by directors and then subsequently by the auditor depending upon the individual circumstances of the company.

If during the going concern assessment process there emerge doubts about the ability of a company to remain a going concern, this does not necessarily mean that the company is or is likely to become insolvent. The solvency of a company is determined by comparing its assets and liabilities along with its ability to meet liabilities as they fall due (See related *Insolvency and going concern discussion* on page 33).

When the directors are unable to state that the going concern basis is appropriate they should consider seeking professional advice including legal advice especially with regard to directors' obligations under the law.

Australian Accounting Standards also require the financial statements to include certain disclosures relevant to the overall going concern assessment, including liquidity risk, where the statements are prepared in accordance with the *Corporations Act 2001*. These disclosures when taken as part of the complete set of financial statements facilitate the directors' declaration regarding the financial statements representing a "true and fair view"[7] of the company's position at reporting date.

7. The "true and fair view" requirement is found in the *Corporations Act 2001* section 297. Accounting Standard AASB 101 (Revised September 2007), paragraph 15, refers to the requirement of fair presentation of financial statements while AUS paragraph 15.1 requires a company preparing a financial report in accordance with the *Corporations Act 2001* to disclose in the notes further information to give a true and fair view.

Listed companies have additional reporting obligations under the *Corporations Act 2001* and the *ASX Listing Rules*. The *ASX Listing Rules* require that the Australian Stock Exchange (ASX) be notified immediately when a company becomes aware of any information that a reasonable person would expect to have a material effect on the price or value of the company's securities (See *Communications issues* on page 47).

Auditor's responsibility to review directors' assessment

The auditor is required by Australian Auditing Standards to review the directors' going concern assumption and to determine if in the auditor's judgment there are events or conditions, which cast significant doubt on the company's ability to continue as a going concern.[8]

When such events or conditions are identified the auditor then uses professional judgment to ascertain if a "material uncertainty" that leads to a significant doubt about the company's going concern status exists (See *The company's interaction with the auditor* on page 39).

- A "material uncertainty" exists when the magnitude of its potential impact is such that in the auditor's professional judgment clear disclosure of the nature and implications of the uncertainty is necessary for the presentation of the financial report not to be misleading.

The going concern review period

The definition of the review period for the assessment of going concern depends upon who is performing the assessment:

For directors

- Australian Accounting Standards require the directors' assessment to be for at least, but not limited to, 12

8. See Compiled Auditing Standard ASA 570, paragraph 16

months from the end of the reporting period (although it could be a longer period).[9]

- The directors' statutory going concern assessment responsibilities are determined by the interaction of the *Corporations Act 2001* and the Australian Accounting Standards and focus mainly on the annual and half-year financial reports. Key processes and procedures that will assist the directors in this process are discussed in the *Key company processes and procedures to facilitate the going concern assessment* on page 22.

For auditors

- Australian Auditing Standards require the auditor to evaluate the directors' going concern assessment using the "relevant period." This period is approximately 12 months from the date that the auditor signs the most recent audit report (typically 2–3 months after the financial year end for companies subject to the *Corporations Act 2001*) to the expected date of the auditor's report for the next reporting period (*see* footnote 5 on page 14).
- Further, Australian Auditing Standards require auditors to ask the directors to extend their own assessment period to correspond to the auditor's assessment period if the former is shorter than the latter.[10]

Therefore it is important to note that ordinarily the directors' going concern assessment period is the same as that of the auditor. However, there may be instances when the directors are unwilling or unable to extend their assessment period as requested by the auditor. In these cases the auditor needs to consider the effect of such response from the directors in the auditor's report on the financial report.

9. See AASB 101, paragraphs 25 and 26
10. See Compiled Auditing Standard ASA 570, paragraph 23

Key company processes and procedures to facilitate the going concern assessment

Directors should plan how they will conduct their going concern assessment process as early as practicable. They will need to apply an appropriate degree of rigour and formality throughout the assessment process. Points to consider include:

- the involvement of the audit committee (or equivalent body) in the assessment process
- the processes and procedures that will be undertaken to support the going concern assessment
- the information that will need to be produced and collected (such as board papers, budgets, cash flows and forecasts) to support their assessment
- comparison of the actual cash-flow position versus the budget/forecast to assess the reliability of the budgeting/forecasting process
- potential wording of going concern related disclosures in the financial report
- whether any remedial action plan may be required
- when it is appropriate to discuss with the auditor their assessment (preferably before financial year-end date).

Early discussions between directors and the auditor will provide the auditor sufficient time to incorporate a timely evaluation of the directors' assessment into their audit planning procedures. It may be useful for a draft of the proposed financial report disclosures about going concern and liquidity risk to be discussed in these meetings.

As a result of such early discussions directors may at least have an opportunity to obtain, adapt, or develop and implement their assessment plan to address any of the auditor's feedback—for example, they may be able to obtain further supporting documentation or develop and implement a remedial action plan. Therefore, appropriately addressing these issues well before the preparation of the financial report (to be incorporated in the annual report) can help avoid any last minute going concern related issues for the company. Consequently this may in turn minimise the risk of the auditor issuing a qualified audit opinion due to scope limitation or inadequate financial report disclosures of going concern issues.

Notwithstanding these early discussions directors still need to consider updating their going concern assessment if there are any events subsequent to the end of the reporting period up to the date the directors approve the financial report which could impact the assessment. Further, the auditor is required by Australian Auditing Standards to make their final evaluation as at the date when the directors approve the financial report and then the auditor signs the audit report.

In order to identify these subsequent events and assess their potential impact directors should ensure the company has appropriate internal processes and procedures in place. These may include:

- updated cash flow forecasts and budgets prepared
- latest available management accounts reviewed
- documented and finalised borrowing arrangements
- management of loan balances including monitoring of repayments and cash flows
- consideration of any contingent liabilities or commitments
- identification and consideration of any change in market conditions for the company's products or services
- documented and active financial risk management processes
- identification of key customer or supplier agreements signed after financial year-end date
- financial adaptability
- other relevant factors.

Examples of possible events or conditions which may affect the going concern assumption

There are certain events or conditions that by themselves or collectively may call into question the appropriateness of the going concern assumption in the preparation of a financial report. Once identified such events or conditions will necessitate an analysis of their impact on the company's going concern status. Difficult or uncertain economic conditions are likely to increase key business risks in many companies that may in turn affect the financial report disclosures including going concern. For example, difficult economic conditions may cause trading third parties (including suppliers and customers) to limit finance available. Other finance providers may also be more risk averse when considering whether to provide, renew, or vary finance facilities.

Directors will need to consider carefully the company's position in light of the information available to them and the assumptions as to the future availability of finance. Further, directors also need to ensure that management has appropriate processes and systems in place to provide adequate supporting documentation for directors and auditors in assessing going concern.

Compiled Auditing Standard ASA 570 *Going Concern* contains a non-exhaustive list of possible events or conditions that may create financial, operating and other business risks that individually or collectively may cast significant doubt on the appropriateness of the going concern assumption.[11] Directors may find this list helpful when conducting their going concern assessment. The list includes the following events or conditions:

- a net liability or net current liability position
- negative operating cash flows
- fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment, or excessive

11. See Compiled Auditing Standard ASA 570, paragraph 13

reliance on short-term borrowings to finance long-term assets
- indicators of withdrawal of financial support by lenders
- withdrawal or variation of credit terms by creditors
- major debt repayment falling due where refinancing is necessary to the company's continued existence
- inability to comply with the terms of loan agreements or to pay creditors on due dates
- loss of a major market, franchise, licence or principal supplier and/or key customer
- indicators of the company's inability to handle increased competition in a shrinking market
- loss of key management without replacement
- failure of other companies with similar structures and comparable operations in the same industry.

Appendix 1 contains a checklist of additional possible events and conditions that may affect the going concern assessment/assumption. Refer AUASB Bulletin *Auditing Considerations in an Uncertain Economic Environment* (April 2009) for further information.

Financial reporting areas that may be affected by difficult or uncertain economic conditions

A difficult or uncertain economic climate may directly affect the underlying accounting and disclosure of certain financial reporting areas. Consequently, this may impact the auditor's judgment of whether the going concern assumption is appropriate. Examples of such areas include:

- asset impairments
- fair value calculations and accounting estimates
- goodwill and intangibles
- recoverability of receivables
- loan impairments

- inventory obsolescence
- accounting for income taxes
- underlying systems of internal control.

Appendix 2 includes a checklist of risk factors that may affect certain financial reporting areas in periods of uncertain or difficult economic conditions. These factors may impact the auditor's professional judgment as to whether the directors have performed an adequate going concern assessment and if the auditor agrees with the directors' assessment.

The significance of identified events or conditions will vary from company to company

It is recognised that the existence of one or more relevant events or conditions (as listed previously) does not always signify that a material uncertainty exists that casts significant doubt on the company's ability to continue as a going concern. However, in a difficult or uncertain economic climate their significance may have increased, requiring directors to consider or re-consider them with more rigour and formality.

It should be noted that even if directors identified such events or conditions particularly those related to cash flow or solvency their significance might be mitigated by other factors.[12] Examples of these mitigating factors include:

- availability of unused lines of credit or similar borrowing capacity
- capability of renewing or extending the due dates of existing loans
- capability of obtaining additional equity contributions
- possibility of reducing overhead and administrative costs
- possibility of using assets for factoring, sale and leaseback or similar arrangements
- ability to adopt alternative strategies that mitigate an uncertainty.

12. See Appendix 2 of Compiled Auditing ASA 570

The following are examples where identified events or conditions could be successfully mitigated by other factors:

- being unable to make debt repayments from operating cash flows may be counterbalanced by management's plans to maintain adequate cash flows by alternative means, such as by disposal of assets, rescheduling loan repayments, or obtaining additional capital
- when the impact of the loss of a key customer is alleviated by an increase in the company's trading transactions with its other customers; or
- when the loss of a principal supplier is mitigated by the availability of another suitable source of supply.[13]

When auditors assess the appropriateness of these mitigating factors in reducing the risks that will more likely result in going concern issues they look for evidence (for example, documentation) supporting:

- the effectiveness of strategies that directors believe will mitigate events or conditions that give rise to a material uncertainty
- the ability of management to execute such strategies.

The relationship between going concern and liquidity risk disclosures in the financial report

"Liquidity risk" is the risk that a company will encounter difficulty in meeting its obligations associated with financial liabilities. It is therefore interrelated to going concern. In difficult or uncertain economic conditions, a credit crunch (that is, tightening of money supply) typically increases liquidity risk which consequently will make it a significant risk for many companies.

In terms of financial report disclosures directors will need to

13. See Compiled Auditing Standard ASA 570, paragraph 13

pay particular attention to the adequacy of their liquidity risk disclosures as well as ensuring there is appropriate supporting documentation to substantiate the disclosures. Auditors will need to consider management's processes for preparing these disclosures, the disclosures themselves, and their consistency, relationship with and support for the going concern assumption.

Recent Australian Accounting Standard changes related to liquidity risk disclosures have been significant and include the requirements to disclose in the financial report:

- risks arising from financial instruments including liquidity risk where it is material
- estimating future cash flows (in connection with estimating the recoverable amounts of assets)
- un-drawn borrowing facilities and any restrictions such as covenant requirements where relevant
- defaults and covenant breaches and potential reclassification of loans in default as current liabilities
- key sources of estimation uncertainty about the carrying amounts of assets and liabilities
- capital and other commitments not recognised in the financial report.[14]

In particular, Accounting Standard AASB 7 *Financial Instruments: Disclosures* requires a company to make both qualitative and quantitative disclosures in the financial report concerning liquidity risk where it is assessed as a material financial risk by directors. Such disclosure requirements include:

- disclosure of information including sensitivity analysis that enables users to evaluate the nature and extent of the company's exposure to liquidity risk

14. Relevant accounting standards include AASB 7 *Financial Instruments: Disclosures*, AASB 136 *Impairment of Assets*, AASB 107 *Cash Flow Statements*, and AASB 101 *Presentation of Financial Statements*

- narrative disclosures explaining how liquidity risk arises in the business and how it is managed in practice
- summary numerical data about liquidity risk based on the information that is provided to directors and other key management personnel
- certain mandatory disclosures such as a maturity analysis of financial liabilities.[15]

These financial report disclosures are supplemented by other Australian Accounting Standard requirements related to liquidity and going concern. For example:

- AASB 107 *Cash Flow Statements* requires disclosure of un-drawn borrowing facilities where relevant to users' understanding of the financial position and liquidity of the company
- AASB 101 *Presentation of Financial Statements* requires:
  - disclosure of defaults and breaches of borrowing terms and conditions in certain circumstances
  - disclosure of capital and other expenditure commitments
  - disclosure of how the entity manages its capital (objectives, policies and procedures).

The Australian Securities and Investments Commission (ASIC) reviews selected lodged financial reports for complaince with the reporting requirements of the *Corporations Act 2001* including accounting standards. For example, during its review of 30 June 2008 financial reports[16] ASIC found that while most companies made required AASB 7 disclosures many companies could have

15. AASB 7 was further amended in March 2009 with early adoption available for annual reporting periods beginning before 1 January 2009 (that is for example, annual periods ending at 30 June 2009)
16. ASIC review of 30 June 2008 reports and areas of focus for upcoming reporting period, Media release 08–218, 3 December 2008 http://www.asic.gov.au

provided better information to explain the risks associated with financial instruments and how they are managed. Some companies were assessed as having provided minimal disclosures that did not follow the principles and intent of AASB 7.

Further, a number of companies did not meet certain specific disclosure requirements resulting in:

- lack of information about security provided on borrowings
- poor disclosure of debt maturity profiles
- insufficient disclosure of risks associated with financial instruments
- poor disclosure of hedging arrangements.

Additional risk disclosures for listed companies

Principle 7 of the ASX *Corporate Governance Principles and Recommendations* (2nd edition) *Recognise and Manage Risk*[17] states that companies should establish a sound system of risk oversight and management and internal control. The principle says that companies should establish policies for the oversight and management of material business risks; that risk management and internal control systems are established; and that the directors' declaration (required by section 295A of the *Corporations Act 2001*) is founded on a sound system of risk management and internal control. If the company has not followed the principle's recommendations it is required to disclose why not (the "if not, why not" approach) in its annual report within the Corporate Governance section. Supplementary guidance to assist with the interpretation of Principle 7 was issued by the ASX Corporate Governance

17. ASX Corporate Governance Council, *Corporate Governance Principles and Recommendations* (2nd edition, August 2007). See especially Principle 7: Recognise and Manage Risk on http://www.asx.com.au/about/corporate_governance/revised_corporate_governance_principles_recommendations.htm

Council on 30 June 2008 to assist listed companies seeking to develop an appropriate risk management system.

Further ASX Listing Rules related to listed companies are discussed under *Communication issues* on page 47.

Insolvency and going concern

Key points:

- ➢ Determining solvency is different to assessing going concern.
- ➢ The assessment of solvency is effectively a day-to-day activity. Directors assess a company's ability to continue as a going concern when half-yearly and annual financial reports are approved for issuance.
- ➢ An unqualified audit opinion with an "emphasis of matter" paragraph related to going concern in an auditor's report does *not* mean a company is insolvent.

When is a company "insolvent"?

The *Corporations Act 2001* defines "solvency" as being able to pay all one's debts, as and when they become due and payable. A director is assessed as having allowed a company to trade while insolvent when he or she has allowed the company to incur new debts when there are not reasonable grounds to believe that it will be able to pay its debts as they become due and payable.

It has been said that determining whether a company is insolvent at a point in time is more art than science. Hence, it is essential that directors of a company facing significant financial uncertainty (for example, cash flow issues) seek independent professional advice including legal advice if they have any concerns about the company being a going concern or believe it could become technically insolvent. This helps ensure that they comply with their legal obligations as a director.

What are the consequences of insolvent trading?

There are a number of potential consequences if a company becomes insolvent:

- a voluntary administrator may be appointed by the directors or secured creditors
- the company may be wound up by the courts or

- in the event that there is a secured debt, a receiver may be appointed over the assets of the company.

In terms of consequences for the directors of the company that has been allowed to trade whilst insolvent the *Corporations Act 2001* provides for substantial civil and criminal penalties to be imposed as well as compensation proceedings to be brought personally against a director. Any pecuniary penalties imposed on a director are not reimbursable under the terms of director and officer insurance policies.

When, and over what period, is solvency determined?

Directors have an obligation to review and assess a company's solvency throughout the year, not just at year end/half yearly reporting dates or when signing solvency resolutions. Solvency determinations are therefore a day-to-day matter for management and directors to manage. In connection with the question of insolvency generally and whether a company is solvent, directors may find the following comments from Palmer J in *Hall v. Poolman* (2007) helpful:

> There is sometimes no clear dividing line between solvency and insolvency from the perspective of the directors of a trading company which is in difficulties. There is a difference between temporary illiquidity and "an endemic shortage of working capital whereby liquidity can only be restored by a successful outcome of business ventures in which the existing working capital has been deployed."…The first is an embarrassment, the second is a disaster. It is easy enough to tell the difference in hindsight, when the company has either weathered the storm or foundered with all hands; sometimes it is not so easy when the company is still contending with the waves. Lack of liquidity is not conclusive of insolvency, neither is availability of assets conclusive of solvency.…
>
> Where a company has assets which, if realised, will pay

outstanding debts and will enable debts incurred during the period of realisation to be paid as they fall due, the critical question for solvency is: how soon will the proceeds of realisation be available…As a very broad general rule, a director would be justified in "expecting solvency" if an asset could be realised to pay accrued and future creditors in full within about 90 days….

The position becomes murkier the less certain are the outcomes e.g.: the market value of the asset may not be ascertainable until the market is tested, so that it is not certain that the realisation will pay in full both existing debts and those to be accrued during the realisation period. The time at which the proceeds of realisation become available may depend upon the state of the market and the complexity of the transaction.

There comes a point where the reasonable director must inform himself or herself as fully as possible of all relevant facts and then ask himself or herself and the other directors: "How sure are we that this asset can be turned into cash to pay all our debts, present and to be incurred, within 3 months? Is that outcome certain, probable, more likely than not, possible with a bit of luck, possible with a lot of luck, remote, or is there is no real way of knowing?"

If the honest and reasonable answer is "certain" or "probable", the director can have a reasonable expectation of solvency.

If the honest and reasonable answer is anywhere from "possible" to "no way of knowing", the director can have no reasonable expectation of solvency.

If the honest and reasonable answer is "more likely than not", the director runs the risk that a court will hold to the contrary in an insolvent trading claim.

If the honest and reasonable answer is "no way of knowing yet, we need more information", the director

> must then ask: "How long before we have the information so that we can give a final answer?"
>
> If the honest and reasonable answer to that question is: "By a definite date which will not extend the realisation period (if there is to be one) beyond 3 months", the director may reasonably say: "Let's wait until then before deciding".
>
> If the honest and reasonable answer is "there is no way of knowing yet when we will have the information to make a decision", the director must say: "Then there is no way that we can now have a reasonable expectation of solvency and there is no way we can reasonably justify continuing to trade without knowing when we will know whether the company is insolvent. Call the administrators". By this series of questions and answers I do not mean to lay down some pro forma test of directors' liability for insolvent trading. Each case depends on its particular facts. These questions and answers merely serve to illustrate that when a company is struggling to pay its debts, the directors must face up to the issue of insolvent trading directly and with brutal honesty: they must not shirk from asking themselves the hard questions and from acting resolutely in accordance with the honest answers to those questions.[18]

Directors' resolution of solvency

At least annually (and half-yearly in the case of listed companies) the *Corporations Act 2001* requires directors of certain entities to make a resolution of solvency. This resolution states that in their opinion "there are reasonable grounds to believe that the company will be able to pay its debts as and when they become due and payable". The directors' declaration included in the financial report prepared

18. *Hall v. Poolman* (2007) 65 ACSR 123 [266]–[276]

under the *Corporations Act 2001* must refer to this resolution. In making this resolution, directors must ensure that:

- the resolution is made at the date of the directors' statement, not as at the end of the financial reporting period (that is, balance sheet date). Consequently the impact of transactions and conditions (that is, subsequent events) that have arisen in the intervening period must be taken into account
- the period of assessment being considered for solvency is not limited to only the period until the next directors' resolution although this period is the main focus. If events or conditions exist further into the future, which are now known to impact the company's solvency, then these should also be taken into account.

Appendix 3 contains example going concern disclosures illustrating how directors might explain their going concern assessment in the *Directors' Report* taking account of difficult or uncertain economic conditions.

ASIC has also provided guidance on events or conditions directors should take into account when formulating their declaration of solvency. Among the matters which should be considered are:

- profit and cash flow budgets (the latter including, where appropriate, any repayments of loans where no fixed repayment dates have been stipulated);
- the ability to realise current assets particularly inventories and receivables;
- the ability to comply with normal terms of credit;
- the possibility of removal of financial support by major lenders;
- the material effect of any contingent liabilities.[19]

19. Refer ASIC Regulatory Guide 22: *Directors' Statement as to Solvency* on http://www.asic.gov.au/

How does determining solvency differ from assessing going concern?

As discussed above a company is a going concern when it is considered to be able to pay its debts as and when they are due and continue in operation for at least the next 12 months without any intention or necessity to liquidate or otherwise wind up its operations. In comparison a company is insolvent when it is unable to pay all its debts when they become due and payable. Unlike the day-to-day assessment of solvency directors are only required to assess a company's ability to continue as a going concern each time the financial report is prepared and approved for issuance—annually for all companies under the *Corporations Act 2001* and in addition half-yearly for listed companies.

The company's interaction with the auditor

Key points:

- ➢ The auditor has a responsibility to evaluate the directors' going concern assessment.
- ➢ Directors have a responsibility to document their assessment including supporting assumptions.
- ➢ Directors should also seek to ensure that management has appropriate processes in place to provide sufficient evidence needed by the auditor.

Auditor's evaluation of directors' going concern assessment

Below is a discussion of the auditor's responsibilities for evaluating the directors' assessment of going concern throughout the audit process. Directors should find this discussion helpful in ensuring that their assessment meets the auditor's requirements.

Compiled Auditing Standard ASA 570 *Going Concern* requires the auditor to consider:

- the appropriateness of the directors' use of the going concern assumption in the preparation of the financial report
- whether there are material uncertainties about the company's ability to continue as a going concern that need to be disclosed in the financial report.

In evaluating the directors' assessment the auditor will review and consider:

- the process the directors followed to make their assessment
- the reasonableness of the assumptions on which the assessment is based
- the available documentation supporting the assessment
- the use of external advisers (for example, legal counsel, valuers, consultants)

- the directors' plans for future action
- whether the directors' assessment is consistent with and takes into account all relevant information the auditor has become aware of.[20]

Specific audit procedures the auditor may use[21] include:

- analysing and discussing with management the company's current and forecast cash-flow position, profit and loss, overall balance sheet position, and other relevant budget forecasts
- comparing for reasonableness and consistency the forecast information to the audited financial report
- reviewing management's previous forecast to actual results to gauge management's accuracy in forecasting
- considering the reliability of the company's information systems in being able to generate such information
- forming a conclusion on whether there is adequate support for the assumptions underlying the forecast
- reviewing the terms of any loan agreements to determine whether any conditions have been breached or are likely to be breached in the period being considered
- considering the company's plans to deal with unfilled customer orders
- confirming whether arrangements with related and third parties for financial support exist and are enforceable and assessing such parties' financial ability to provide funding
- reading minutes of the meetings of shareholders, boards, and relevant committees (for example, audit committee or governance/risk committee) for any discussions concerning the company's solvency, going concern, or financial difficulties
- reviewing events or conditions that have occurred

20. See Compiled Auditing Standard ASA 570, paragraph 25
21. See Compiled Auditing Standards SAS 570, paragraph 33

subsequent to year end for any evidence of factors that may affect the company's ability to continue as a going concern.

The auditor may decide that it is appropriate to request from the directors a written representation on specific matters relating to their going concern assumptions and plans.[22] Such a representation would typically include the directors' confirmation that they have provided the auditor with all of the available information/documentation regarding all significant events and conditions taken into account in the directors' assessment of going concern.

Auditor's consideration of directors' strategies that mitigate events or conditions giving rise to a material uncertainty

If the auditor in assessing the directors' strategies for mitigating identified events or conditions that may lead to a material uncertainty has found that such strategies:

- are realistic
- have a reasonable expectation of resolving identified problems
- are likely to be effectively put into place by the directors
- if appropriate, are adequately disclosed in the notes to the financial statements,

then the auditor exercises professional judgment and decides what impact, if any, these strategies have on the auditor's evaluation of the adequacy of the going concern assessment.

Evaluating the adequacy of disclosures about going concern

Disclosures in the financial report

An essential quality of the information and disclosures provided in the financial report is that they are readily understandable by

22. See Compiled Auditing Standard ASA 570, paragraph 31

users.[23] Directors are responsible for ensuring that management prepares a financial report that gives a true and fair view of the company's financial position, cash flows and its results from operations. The auditor in reviewing the financial report (incorporating the complete set of financial statements) considers whether all the disclosures present a true and fair view of the company. The understandability of the disclosures is an important factor in determining whether the financial report gives a true and fair view.[24]

When the directors have included disclosures (ordinarily in *Note 1 to the Financial Statements*) documenting material uncertainties while asserting the going concern assumption continues to be the basis of preparation of the financial report the auditor needs to carefully review and consider the adequacy of these disclosures. In particular disclosures relating to:

- the principal conditions which caused the auditor to question the going concern assumption including as appropriate, the directors' evaluation of their significance and possible effects
- the directors' plans and other mitigating factors including as appropriate relevant prospective financial information[25]

need to be evaluated by the auditor as part of determining the adequacy of the disclosures and potentially their type of audit opinion.

Disclosures in the *Directors' Report*

In addition to the disclosures in the financial report directors are also responsible for preparing the *Directors' Report* which is

23. AASB 101 *Presentation of Financial Statements* states that "the objective of financial statements is to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions".
24. See AASB 101, paragraph 15 and the *Corporations Act 2001*, section 297
25. See Compiled Auditing Standard ASA 570, paragraph 36.

incorporated in the company's annual report. The *Directors' Report* ordinarily presents the principal activities of the company; results and review of operations; significant changes in the state of affairs; business strategies, developments and expected results which may include the directors' assessment of the company's ability to continue as a going concern. The auditor is required by Australian Auditing Standards to read the *Directors' Report* to determine whether there is any inconsistency between such a report and the audited financial report. If the auditor identifies any inconsistency the auditor is required to evaluate the need to amend any information in the audited financial report.[26]

Appendix 3 includes examples of directors' disclosures regarding going concern related issues in the *Directors' Report*.

Implications for the auditor's report

Types of audit opinions

The conclusion the auditor draws about the directors' going concern assessment and liquidity risk disclosures (as disclosed in the financial report) will determine the consequences for the type of opinion expressed in the auditor's report. The auditor may issue one of five possible audit opinions. In order of impact on the company, ranging from favourable to unfavourable the auditor may:

- issue an unqualified opinion
- issue an unqualified opinion, but include an emphasis of matter paragraph
- issue a qualified opinion
- issue an adverse opinion or
- issue a disclaimer of opinion.

An unqualified audit opinion is one where the going concern basis is determined by the auditor to be appropriate.

26. See Auditing Standard ASA 720 *Other Information in Documents Containing Audited Financial Reports*

The impact of going concern related issues on the auditor's opinion is discussed below. It is important to understand the difference between an "unqualified opinion with an emphasis of matter paragraph", a "qualified opinion", and an "adverse opinion", as there are common misunderstandings of what they mean:

- *Unqualified opinion, with an emphasis of matter paragraph:* If the auditor concludes that a material uncertainty exists that leads to significant doubt about the ability of the company to continue as a going concern *and* the uncertainty has been adequately disclosed in the financial report the auditor is required to express an unqualified opinion, but add an "emphasis of matter" paragraph for the purpose of drawing attention to such disclosures.[27] While an emphasis of matter paragraph modifies the audit report, it does *not* qualify the opinion.

- *Qualified and adverse opinion:* If the auditor concludes that the financial report disclosures regarding a material uncertainty that leads to significant doubt about the company's going concern status are not adequate the auditor is required to express either a qualified opinion or an adverse opinion as appropriate and to provide their reasons for doing so.[28]

The distinctions between a "qualified opinion" and an "adverse opinion" are as follows:

- The auditor expresses a *qualified opinion* when in the auditor's professional judgment the effects of inadequate disclosures on the financial report of uncertainties that lead to a significant doubt about the company's ability to continue as a going concern are not so material and pervasive to the financial report as to require an adverse opinion or a disclaimer of opinion.

27. See Compiled Auditing Standard ASA 570, paragraphs 37 and 39
28. See Compiled Auditing Standard ASA 570, paragraph 41

- The auditor expresses an *adverse opinion* when in the auditor's professional judgment:
  - the effects of inadequate disclosures on the financial report (as discussed above) are so material and pervasive that a qualified opinion is not sufficient to disclose the incomplete or misleading nature of the financial report resulting from such inadequate disclosures *or*
  - the company cannot continue as a going concern despite the financial report having been prepared on that basis.

The auditor expresses a *disclaimer of opinion* when in the auditor's professional judgment:

- there is a limitation on the scope of the audit (for example, the directors refuse to make or extend their going concern assessment) and the effect of such limitation is so material and pervasive to the financial report that the auditor has been unable to obtain sufficient appropriate audit evidence to complete the audit and subsequently to express an audit opinion on the financial report.[29]

A table and diagram showing the various types of opinions that an auditor might draw from the directors' assessment of going concern are included at appendices 4 and 5.

Reporting to ASIC

Auditors are required by s.311 of the *Corporations Act 2001* to report to ASIC when they have reasonable grounds to suspect circumstances that amount to a significant contravention of the *Corporations Act 2001*. Such reporting is required to be made as soon as practicable or within 28 days of the auditor becoming

29. See Compiled Auditing Standard ASA 701 *Modifications to the Auditor's Report*, paragraphs 21–25, for a discussion of matters that affect the auditor's opinion

aware of the circumstances. This would include if the auditor has reasonable grounds to believe that the directors have made a false statement of solvency or are allowing a company to trade while insolvent.

It is important to note that the auditor is required to report to ASIC based on "reasonable grounds to suspect" only—proof is not required. There are further ASIC reporting requirements for auditors under ss.601HG and 990K of the *Corporations Act 2001*, related to managed investment schemes and financial services licensees and businesses respectively. Refer ASIC *Regulatory Guide 34: Auditors' Obligations: Reporting to ASIC* for further information.

Communication issues

Key points:

- Listed companies have continuous disclosure obligations under the *Corporations Act 2001* and *ASX Listing Rules*.
- ASX may suspend a listed company where it forms the view that the company is not a going concern.
- Transparent and timely communications of going concern related issues are critical.

ASX Listing Rules applicable to listed companies re going concern

The following *ASX Listing Rules* relate to a listed company's disclosure obligations around going concern or solvency. Where contraventions of the rules have occurred it also includes a discussion of the ASX's power to suspend their securities from quotation.

Listing Rule 3.1—continuous disclosure

Continuous disclosure is the timely advising of information to keep the market informed of events and developments as they occur.

ASX Listing Rule 3.1 requires that once a company is or becomes aware of any information concerning it which a reasonable person would expect to have a material effect on the price or value of the company's securities, the company must immediately tell ASX that information. The appointment of a receiver, manager, liquidator or administrator in respect of any loan, trade credit, trade debt, borrowing or securities held by it or any of its child entities, if material under this rule, would require immediate disclosure.

Listed companies have obligations under ASX Listing Rule 3.1 in relation to any expected material variations in their financial results. In this regard, the ASX issued a Companies Update in January 2009: *Profit Warnings and other Announcements of Expected Material Differences in Financial Results*.[30] Following are some key points from the ASX Companies Update.

Companies are required to make an appropriate ASX announcement immediately after they become aware that there is expected to be a material difference in the financial results for that period from the results that were recorded in the previous corresponding period or from forecasts for that period that have been provided to the market by the company or (in some cases) from analysts' consensus forecasts.

The disclosure must be made immediately after the company becomes "aware" of any information concerning it that a reasonable person would expect to have a material effect on the price or value of the company's securities. *(Listing Rule 3.1)*

"Aware" is defined in Chapter 19 of the Listing Rules:

- An entity becomes aware of information if a director or executive officer (in the case of a trust, a director or executive officer of the responsible entity) has, or ought reasonably to have, come into possession of the information in the course of the performance of their duties as a director or executive officer of that entity.

However, it should be noted that Listing Rule 3.1 includes exceptions where the information is confidential, that is where a reasonable person would not expect the information to be disclosed and where the information is generated for internal management purposes of the company or comprises a matter of supposition or is insufficiently definite to warrant disclosure.

Guidance Note 8 to the Listing Rules (Listing Rule 3.1) was issued to assist listed companies to comply with their continuous

30. A copy of this ASX Companies Update is found at http://www.asx.com.au/resources/newsletters/companies_update/archive/CompaniesUpdate_20090122_0109_HTML.htm

disclosure obligations and outlines ASX's expectations in relation to best disclosure practice. Relevant provisions of *Guidance Note 8* include:

- Once a director or executive officer becomes aware of information, they must immediately consider whether that information should be given to ASX. For example, a company cannot delay giving information to ASX pending formal sign-off or adoption by the board. (paragraph 18)
- A material change in the company's previously released financial forecast or expectation must be disclosed. A variation in excess of 10% to 15% is generally considered to be material, and should be announced by the company as soon as the company becomes aware of the variation. If the company has not made a forecast, a similar variation from the previous corresponding period will need to be disclosed. In certain circumstances, a smaller variation will be disclosable. (paragraph 93)
- In making a disclosure, the company must provide some details of the extent of the variation. For example a statement by a company may indicate that, based on internal management accounts, its expected net profit or EBIT (earnings before interest and tax) will be an approximate amount (e.g. approximately $6m) or alternatively within a stated range (e.g. between $5m and $7m). Alternatively, the company may indicate an approximate percentage movement (e.g. "up [or down] by 25%"). The ASX discourages companies from using imprecise terms such as "single digit" and "double digit" when disclosing financial forecasts or profit variations, as they are potentially misleading to investors (paragraph 94)
- In some cases, it may be appropriate for a listed company to disclose material variations from analysts' consensus forecasts and expectations. (paragraph 95)

The January 2009 Companies Update also highlighted that where a listed company reports results that have varied by greater than 10 per cent to 15 per cent, the ASX will undertake a review of previous announcements made by that company during and after the financial reporting period to determine if continuous disclosure obligations have been met.

The ASX also reviews companies whose financial report discloses variations of approximately that size from:

- the results in the previous corresponding reporting period or
- from forecasts or earnings guidance previously released by the company itself or
- in appropriate cases, from analysts' consensus forecasts.

Where it does not appear from that review that an announcement indicating the likelihood of a material variation in the results had been made prior to the release of the periodic financial report ASX can write to the company asking it to state when it first became aware that there would be such a variation. If ASX decides to write to the company in order to confirm that the company has met its continuous disclosure obligations it is important to note that copies of correspondence between ASX and the company may be released to the market.

Listing Rule 12.2 On-going requirements—Financial condition

Listing Rule 12.2 states that a company's financial condition (including operating results) must in ASX's opinion be adequate to warrant the continued quotation of its securities and its continued listing. It is a continuing obligation that preserves the quality of listing. It seeks to ensure that a listed company has sufficient financial strength to justify its listing with the ASX. ASX's view is that if the company is not a going concern its financial condition is inadequate to warrant quotation.

Listing Rules 17.1, 17.2, and 17.3 Trading halts, Suspension of securities from quotation

These listing rules deal with trading halts and suspending quotation of a company's securities. ASX will suspend trading in securities of a company if in ASX's opinion it is not a going concern. ASX may also suspend trading in securities of a company that has an Independent Audit Report or Review Report that contains an, "adverse" opinion or "disclaimer" of opinion in respect of its going concern status.

Corporations Act 2001

Directors should be aware that section 674 of the *Corporations Act 2001* provides the mechanism for the enforcement of the continuous disclosure obligations under the *ASX Listing Rules*:

- A person "involved in a contravention" by a listed company of its continuous disclosure obligations will be in breach of section 674(2A) of the Act and will be liable to pay a civil penalty of up to $200,000. Such a person may also be liable under section 1325 of the Act to compensate shareholders who suffer loss as a result of the breach.

Directors may have a defence under section 674(2B) to an allegation of breach if they prove that they took all reasonable steps in the circumstances to ensure that the company complied with its obligations under the Act.

Focus on the particular circumstances of the company

In a difficult or uncertain economic environment full and transparent communications by all companies is critical. The guiding principle in communications to the market is: "Tell the good news fast and the bad news faster".

Companies should clearly articulate any uncertainties around the going concern assumption together with how they propose to deal with them. When the company has issued a financial report with an auditor's report containing an unqualified opinion with an emphasis of matter paragraph the company should make stakeholders (for example, investment community, shareholders, and lenders) aware that the emphasis of matter paragraph does not necessarily imply the company is not a going concern or is nearing insolvency.

An example situation where a question regarding a company's going concern status could arise when a lender is reluctant to confirm that its current facility will be available after expiration of the facility. However, there may be a number of reasons why a lender may be reluctant to confirm such a matter and it would not mean that the company is not a going concern at the date the financial report is finalised. This situation can arise when:

- In difficult or uncertain economic conditions banks or other lenders as a matter of policy refuse to provide such confirmations to their customers or their auditors.
- The company and its lenders are engaged in negotiations about the terms of a facility (for example, the interest rate) and there is no evidence that the lender is reluctant to lend to the company.
- The lender renewed a rolling facility immediately prior to the date of the issuance of the annual report and financial report and is reluctant to go through the administrative burden to confirm that the facility will be renewed on expiry.

Where the company has disclosed the circumstances giving rise to the uncertainties in the notes to the financial statements while still concluding that the going concern basis is appropriate and the auditor agrees with the disclosure the auditor typically expresses an unqualified opinion with an emphasis of matter paragraph. The purpose of the paragraph is to draw attention to the directors' disclosure in the notes to the financial statements of material uncertainties related to going concern.

If the company is facing significant uncertainties about its funding sources (for example, a withdrawal of key borrowing facilities) which call into question the company's ability to continue as a going concern then the directors will need to carefully consider what strategies are available to them which could mitigate such uncertainties. These strategies should then be discussed with the auditors (as described previously). This will enable the auditors to evaluate these strategies and consider their impact on the auditor's opinion. The directors will also need to explain to the market their strategies for dealing with these uncertainties.

Some example *Directors' Report* disclosures are set out in *Appendix 3* which are illustrative only. In practice such disclosures must be tailored to the specific individual circumstances of each company.

APPENDICES

Appendix 1—checklist of possible events and conditions that may affect the assessment of going concern

Examples of possible events and conditions that may be relevant to the assessment of going concern include:

Obtaining external finance:

- Company has experienced difficulties in the past in obtaining external finance facilities and/or in complying with the related terms and covenants.
- Borrowing agreements or executory contracts include clauses relating to debt covenants at call terms or subjective clauses (for example, a "material adverse change clause" or share price declines below a certain dollar value) that trigger full or partial repayment of the amount borrowed.
- Company has breached some of the terms or covenants of the borrowing agreements giving rise to the risk that the facilities may be withdrawn or not renewed.
- Finance facility is secured on assets (for example, properties) that have decreased in value below the amount of the facility.
- Finance facilities are due for renewal in the next year.
- Management have no plans for alternative arrangements should current facilities not be extended.
- Company is dependent upon funding from a related or third party that is experiencing financial difficulties.
- Financing is provided by a syndicate of banks and other financial institutions and there are concerns about the viability of one or more of the members of the syndicate.

Management plans to overcome financing difficulties include disposal of assets or possible rights issues:

- Plans developed prior to the onset of challenging or uncertain economic conditions have not been updated.
- Lack of evidence that management can realise the assets to be disposed of at the expected values.
- Shareholders' support uncertain in relation to a planned rights issue.
- Possible "lukewarm" reception of prospective investors to share issuance due to the company's poor financial performance.

Company provides significant loans or guarantees to related parties or third parties:

- Guarantees that may be called in.
- Borrowers who/which may be unable to make payments.

Company dependent upon guarantees or financial support provided by a third party:

- Guarantor no longer able/prepared to provide the guarantee.
- Financial support withdrawn or in doubt.

Future cash flows:

- Reduction in cash flows resulting from unfavourable economic conditions.
- Major customers taking longer or unable to pay.
- Market for product or services has contracted significantly.
- Terms or covenants of renewed financing are changed and become more difficult to comply with (for example, increased interest rates or charges).
- Company is subject to margin calls as a result of a decrease in fair market value of financial instruments that it holds.

- Company has issued loans (or received borrowings) having an introductory period during which favourable terms are in force which revert to normal market rates in the forthcoming year.

Company heavily dependent upon particular counterparties:

- Suppliers facing financial difficulties provide essential goods/services.
- Company unable to find alternative suppliers.
- Major suppliers tightening their credit terms.
- Key customers experiencing financial difficulties.
- Substantial reduction of orders from key customers.
- Financial instrument counterparties are in default or experiencing difficulty to comply with terms due to cash flow problems.

Appendix 2—checklist of risk factors arising from uncertain or difficult economic conditions

Below are some events or conditions that may increase the risk of material misstatement (hence they are called risk factors) in a company's financial report during difficult or uncertain economic conditions. These factors may impact the auditor's professional judgment as to whether the directors have performed an adequate assessment of going concern issues and whether the auditor agrees with the directors' assessment. As such, directors are encouraged to satisfy themselves that management has provided the necessary information or have the necessary processes in place to obtain the information to support their going concern assessment.

Fair values:

- Company needs to change valuation model and/or management's assumptions to reflect prevailing economic/market conditions.
- Active market no longer exists requiring use of a model for valuation purposes.
- Inputs to a model are not based on observable market inputs, but rather are based on the company's own data.
- Impairment of non-financial assets held at fair value (for example, properties).
- Company uses an external valuation expert for fair value measurements that needs to change its valuation model and/or assumptions to reflect prevailing market conditions.
- Company does not have the necessary in-house expertise to undertake valuations.

Recent amendments to Australian Accounting Standard AASB 139 *Financial Instruments: Recognition and Measurement* permit the reclassification of certain financial assets, out of a "fair value" category in the balance sheet in particular circumstances. This may consequently impact debt covenant calculations.

Impairments:

- Impairments of assets other than those held at fair value (for example, need for increased doubtful debt provisions because previously reliable customers may not be able to pay their debts when due).
- Stock obsolescence resulting from significant decreases in demand for certain types of product.
- Impairment of the carrying amount of purchased goodwill.
- Increasing discount rates used in impairment calculations because capital has become more expensive.
- Effect on impairment calculations of subsequent events in particular those relating to counterparties.
- Difficult credit market conditions may lead to the triggering of acceleration clauses which may lead to the impairment of financial assets.

Current versus non-current classification:

- Difficult market conditions may bring into question the classification of assets and liabilities as current or non-current. (For example, the re-classification of liabilities as a result of a breach of loan covenants).

Revenue recognition:

- Difficult credit market conditions may make it harder to demonstrate that the revenue recognition criteria have been met.

Defined benefit superannuation plans:

- While not common in Australia those companies with defined benefit superannuation plans may see their net obligations increased by reduction in value of assets held in a related defined benefits pension scheme.

- Effect of large exposures to the share market, illiquid investments, and decreases in expected rates of return on investments.
- Increased need to consult an actuary to make valuation or funding judgments.

Hedging:

- Hedging arrangements no longer effective when a derivative counterparty is experiencing financial difficulty or more generally due to widening credit spreads on the derivative counterparty.
- In difficult market conditions hedge effectiveness may have failed either because it is no longer probable that a derivative counterparty will meet its obligations or because counterparty credit spreads, have increased substantially, or because of the effect of changes in inter-bank lending rates on fair value interest rate hedges.
- Fair value of hedging instruments has decreased due to challenging or uncertain economic conditions and resulting losses will impact the company's profitability.

Insurance:

- The ability of an insurance company providing credit insurance to meet claims.

Deferred income taxes:

- If a company is reporting losses or is expected to incur future losses, there may be a need to reduce the carrying amount of deferred tax assets to the extent that it is no longer probable that the assets' benefit will be utilised.

Appendix 3—examples of directors' going concern and solvency disclosures in the *Directors' Report*

Examples of going concern disclosures

The following examples are illustrative only. In practice such disclosures in the *Directors' Report* should be tailored to the specific individual circumstances of each company. It should be noted that these disclosures will need to be reviewed by the auditor as they form part of the annual report. The auditor is required by Australian Auditing Standards to review such information for consistency with the financial report. Where inconsistencies are identified the auditor will raise these with directors in order to resolve them.

Example 1—a group with significant positive bank balances, uncomplicated circumstances and little or no exposure to economic uncertainties which may impact the going concern assumption.

The group's business activities together with the factors likely to affect its future development, performance and position are set out in the Business Review on pages X to Y. The financial position of the group, its cash flows, liquidity position and borrowing facilities are described in the Chief Financial Officer's Review on pages P to Q. In addition note A to the financial statements includes the group's objectives, policies and processes for managing its capital; its financial risk management objectives; details of its financial instruments and hedging activities; and its exposures to credit risk and liquidity risk.

The group has considerable financial resources together with long-term contracts with a number of customers and suppliers across different geographic areas and industries. As a consequence the directors believe that the group is well placed to manage its business risks successfully despite the current uncertain economic outlook.

After making enquiries the directors have a reasonable expectation that the company and the group have adequate resources to continue in operational existence for the foreseeable future. Accordingly they continue to adopt the going concern basis in preparing the financial report.

Example 2—a group with uncomplicated circumstances, some exposure to economic uncertainties and either a current material bank overdraft or loan and a need to renew this facility in the foreseeable future albeit not imminently.

Paragraph similar to *Example 1*, paragraph 1.

As highlighted in note B to the financial statements, the group meets its day-to-day working capital requirements through an overdraft facility which is due for renewal on [date]. The current economic conditions create uncertainty particularly over (a) the level of demand for the group's products; (b) the exchange rate between the dollar and currency X and thus the consequence for the cost of the group's raw materials; and (c) the availability of bank finance in the foreseeable future.

The group's forecasts and projections taking account of reasonably possible changes in trading performance show that the group should be able to operate within the level of its current facility. The group will open renewal negotiations with the bank in due course and has at this stage not sought any written commitment that the facility will be renewed. However, the group has held discussions with its bankers about its future borrowing needs and no matters have been drawn to its attention to suggest that renewal may not be forthcoming on acceptable terms.

Paragraph as per *Example 1*, paragraph 3.

Example 3—a group with complicated circumstances, considerable exposure to economic uncertainties and either a current material bank overdraft or loan which requires renewal and perhaps an increase in the year ahead.

Paragraph as *Example 1*, paragraph 1.

As described in the *Directors' Report* on page X the current economic environment is challenging and the group has reported an operating loss for the year. The directors consider that the outlook presents significant challenges in terms of sales volume and pricing as well as input costs. While the directors have instituted measures to preserve cash and secure additional finance these circumstances create material uncertainties over future trading results and cash flows.

As explained on page X the directors are seeking to sell a property to provide additional working capital. The group is in negotiations with a potential purchaser, but there can be no certainty that a sale will proceed. Based on negotiations conducted to date the directors have a reasonable expectation that it will proceed successfully, but if not the group will need to secure additional finance facilities.

As explained in the Business Review on Page Y the group has commenced discussions with its bankers about an additional facility that may prove to be necessary should the sale of the property not proceed or should material adverse changes in sales volumes or margins occur. It is likely that these discussions will not be completed for some time. The directors are also pursuing alternative sources of funding in case an additional facility is not forthcoming, but have not yet secured a commitment.

The directors have concluded that the combination of these circumstances represent a material uncertainty that casts significant doubt about the group's and the company's ability to continue as a going concern. Nevertheless after making enquiries and considering the uncertainties described above the directors have a reasonable expectation that the group and the company have adequate resources to continue in operational existence for the foreseeable future. For these reasons they continue to adopt the going concern basis in preparing the financial report.

Appendix 4—types of auditor's opinions

The table below shows the five types of audit opinions that the auditor might reach regarding the directors' going concern assessment as disclosed in the financial report. The table shows them in order of impact on the company ranging from favourable (green) to unfavourable (red).

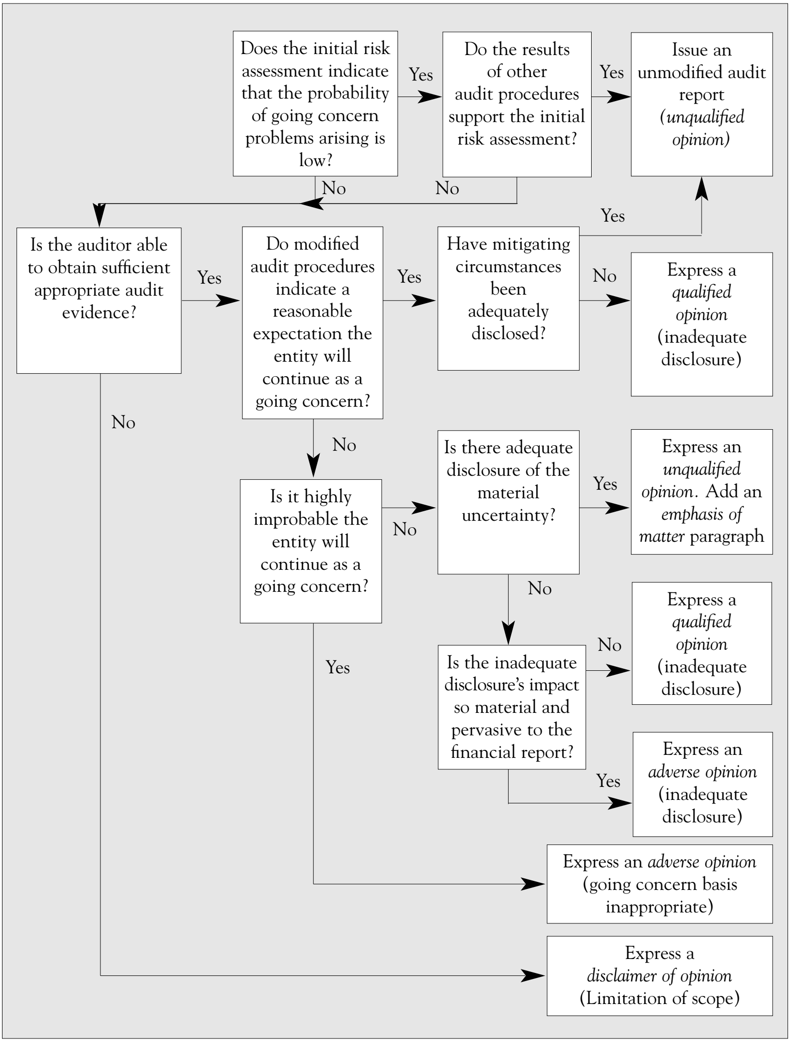
Auditors opinion[31]	Circumstances	Impact for financial report/degree of caution for the company
	Auditor agrees with the directors' assessment and considers disclosures adequate	
Unqualified opinion	Preparing the financial report on the going concern basis is appropriate, the going concern and liquidity disclosures are adequate and there are no material uncertainties that cast significant doubt on the company's ability to continue as a going concern	green
Unqualified opinion but with an emphasis of matter paragraph	Preparing the financial report on the going concern basis is appropriate, but there are material uncertainties that cast significant doubt on the company's ability to continue as a going concern. Such material uncertainties are adequately disclosed in the financial report.	orange
	Auditor agrees with the directors' assessment but considers disclosures inadequate	
Qualified opinion	Preparing the financial report on the going concern basis is appropriate but there are material uncertainties that cast significant doubt on the company's ability to continue as a going concern. Such material uncertainties are not adequately disclosed in the financial report, but the effects of such inadequate disclosures are not so material and pervasive to the financial report as to require an adverse opinion or a disclaimer of opinion.	orange/red

31. See Compiled Auditing Standard ASA 570, paragraphs 35–49

Auditors opinion[31]	**Circumstances**	**Impact for financial report/degree of caution for the company**
Adverse opinion (inadequate disclosure)	Preparing the financial report on the going concern basis is appropriate, but there are material uncertainties that cast significant doubt on the company's ability to continue as a going concern. Such material uncertainties are not adequately disclosed. The effects on the financial report of such inadequate disclosures are so material and pervasive that a qualified opinion is not sufficient to disclose the incomplete or misleading nature of the financial report which results from the inadequate disclosures.	red
Auditor disagrees with the directors' assessment of going concern basis being appropriate		
Adverse opinion (going concern basis inappropriate)	The financial report has been prepared on the going concern basis, but the auditor has concluded that using the going concern basis is inappropriate.	red
The directors refuse to undertake, or extend the assessment period of their going concern assessment		
Disclaimer of opinion	When the directors refuse either to undertake or to extend the period of their assessment of going concern with the result that the auditor is unable to form an opinion on the financial report.	red

31. See Compiled Auditing Standard ASA 570, paragraphs 35–49

Appendix 5—linking the auditor's going concern considerations with types of audit opinions[32]



32. See Compiled Auditing Standard ASA 570 *Going Concern* paragraphs 35–49 (inclusive) and Compiled Auditing Standard ASA 701 *Modifications to the Auditor's Report* for further information

Appendix 6—summary of Australian laws/regulations on going concern

The following outlines the key sources of Australian laws, regulations and guidance around going concern. It is a guide only, is not meant to be exhaustive and directors should refer to the documents below for further information.

Directors' obligations

ASX Listing Rules	Description
ASX Listing Rules	ASX listing rules have no specific requirements to disclose information about whether a company is a going concern.
Listing Rule 3.1	However, under the continuous disclosure requirements in *Listing Rule 3.1* changes in any significant uncertainties or mitigating factors relating to the company's ability to continue as a going concern are likely to require immediate disclosure.
Listing Rule 12.2	*Listing Rule 12.2* (Financial Condition) states that a company's financial condition (including operating results) must in ASX's opinion be adequate to warrant the continued quotation of its securities and its continued listing. ASX's view is that if the company is not a going concern its financial condition is inadequate to warrant quotation.
Listing Rules 17.1, 17.2 and 17.3	*Listing Rules 17.1, 17.2 and 17.3* deal with trading halts and suspending quotation of a company's securities. ASX policy is to suspend companies that have Independent Audit Reports that contain *adverse* audit opinions or *disclaimers* of opinion.

Corporations Act 2001	Description
s.295(4)(c)	Directors must make a declaration in the annual financial report (s.303(4) for half year) whether in the directors' opinion there are reasonable grounds to believe that the company, registered scheme, or disclosing entity will be able to pay its debts as and when they become due and payable.
s.296(1)	Financial reports must be prepared in accordance with accounting standards. (see below)
Chapter 5 *External administration and corporate insolvency*	This chapter covers what happens and what is to be done when a company is insolvent or approaching insolvency including the penalties that apply for breaches of this chapter.
s.588G and subsections	This section discusses the statutory duty of directors to prevent insolvent trading by the company. This includes solvency test for payment of dividends.
ASIC Guidance	**Description**
Regulatory Guide 22 *Directors' statement as to insolvency*	This practice note discusses the obligations of directors in making the statement on the solvency of the company and clarifies the status of the statement required by s.295 (4) of the *Corporations Act 2001*.
Information Sheet 42 *Insolvency: A Guide for Directors*	This information sheet provides general guidance for directors of entities that are insolvent or suffering from financial difficulties and on the different forms of external administration available.

Australian Accounting Standards	Description
AASB 101 *Presentation of Financial Statements* (9/2007)	Under paragraphs 25–26 management must make an assessment of the company's ability to continue as a going concern and only prepare financial statements on a going concern basis (in accordance with Australian Accounting Standards) if it is a going concern. If material uncertainty exists about the company's ability to continue as a going concern then this must be disclosed in the financial statements. This assessment should cover a period of at least, but not limited to, 12 months from the end of the reporting period (see also Auditor's obligations section page 71).
AASB 7 *Financial Statements: Disclosures* (10/2008)	As well as the specific requirements relating to disclosures around the credit, liquidity and market risks associated with financial instruments, AASB 7 requires that a company discloses information that enables users of its financial report to evaluate the nature and extent of risks arising from financial instruments that it is exposed to at the reporting date. Therefore, if financial instruments expose the company to going concern issues or liquidity risks, AASB 7 would require that sufficient information be disclosed such that users can make an assessment of that risk.

Auditor's obligations

Corporations Act 2001	Description
s.311	Auditors are required to report to ASIC when they have reasonable grounds (as opposed to proof) to suspect circumstances that amount to a significant contravention of the *Corporations Act 2001* within 28 days of the auditor becoming aware of the circumstances. This would include if the auditor has reasonable grounds to suspect that the directors have made a false statement of solvency or are allowing a company to trade while insolvent.
s.307	Auditors must comply with Australian Auditing Standards (see page 72).
s.601HG	This section discusses statutory obligations of auditors of managed investment schemes, including reporting responsibilities to ASIC for any significant contravention of the *Corporations Act 2001*.
s.990K	Auditors of financial services licensees are required to report to ASIC any significant contravention of the *Corporations Act 2001* within 7 days after becoming aware of such contravention.

Australian Auditing Standards	Description
Compiled Auditing Standard ASA 570 *Going Concern* (6/2007)	This Standard specifies an auditor's responsibilities and the impact on the audit report if there are going concern issues. An auditor needs to consider the appropriateness of the going concern assumption over the period from the date of the current audit report to the expected date of the next audit report for the corresponding period in the subsequent financial year.

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