Not for Profit

Going concern: Challenges and responsibilities

“I am not going to say that this is an Enron moment, but there has been a collective passing of the buck which I am rather uncomfortable with”

The words of Bernard Jenkin MP, Chair of the Public Administration and Constitutional Affairs Committee during a short Inquiry in autumn 2015 which looked into certain aspects of the closure of Kids Company. This particular comment was made during the session which challenged the role of the charity’s auditors and advisors, and sought to establish why they had not raised concerns at an earlier stage. Clearly in this case, the charity wasn’t the “going concern” that many had assumed it to be, and the PACAC was keen to attribute the blame. As a charity Audit Partner I can certainly identify with the feeling of discomfort particularly in relation to the speed at which things can often go wrong, although would strongly refute that auditors “pass the buck”.

This article is not an analysis of what went wrong at Kids Company – plenty of commentators have put forward their views on that already and undoubtedly will continue to do so for months, if not years, to come. The objective of this piece is, however, to look again at the concept of “going concern”, who is meant to do what, and why it will always be fraught with difficulties.

What is “going concern”?

Underpinning the UK’s Generally Accepted Accounting Practice (UK GAAP) is the assumption that entities’ accounts will be prepared on the “going concern” basis. This fundamental presumption is embodied in Financial Reporting Standard (FRS) 102, the standard which now forms the accounting framework for charities and many other entities preparing accounts in the UK and the Republic of Ireland. It is a longstanding accounting principle which has not changed, so what does it mean?

FRS 102, in paragraph 3.8 and in its Glossary, makes reference to going concern as follows:

“An entity is a going concern unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so”.

Perhaps this highlights one of the initial difficulties relating to “going concern” as this definition explains the term more by what it isn’t than by what it is. As explained further below, it is also defining something relevant now by reference to what may or may not happen in the future, through intention or otherwise.

The International Standard on Auditing (ISA) (UK and Ireland) 570 which deals with Going Concern helps to shed some light on this by stating that “when the going concern assumption is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realise its assets and discharge its liabilities in the normal course of business”. In other words, inherent in the declaration of going concern is the presumption that the entity has neither the intention nor the need to liquidate or curtail materially the scale of its operations, and that the business will remain in existence long
enough for all of its assets to be fully utilised – it won’t be forced to impair them and / or sell them at undervalue.

Another key factor in the appreciation of going concern is the timeframe to which it is assumed to apply. FRS 102 goes on to explain that “in assessing whether the going concern assumption is appropriate, management takes into account all available information about the future, which is at least, but is not limited to, twelve months from the date when the financial statements are authorised for issue”.

This brings a further challenge. A prediction about the future is required which has to ring true for at least 12 months from the date of authorisation of the financial statements, which is usually the date the accounts are signed. The predictive nature of the going concern assumption is also underlined in ISA 570 which explains that “under the going concern assumption, an entity is viewed as continuing in business for the foreseeable future” before going on later to require that management extends its assessment period if the initial period covers less than 12 months from the actual / proposed date of signing the accounts, thus again underlining the importance of the 12 month principle. A couple of further points of clarification are worth mentioning here to avoid common misunderstandings. The period of 12 months is a minimum period; it is also 12 months from the date of signing, not the balance sheet date to which the accounts are drawn up.

How does this affect charities?

Charities preparing financial statements under UK GAAP – i.e. preparing accruals accounts which show a true and fair view – are bound by the same principles embodied in UK GAAP and in FRS 102 as their non-charity counterparts. Charities also have to have regard to the Charities Statement of Recommended Practice (SORP); for charities with accounting periods starting on or after 1 January 2015, this is the Charities SORP (FRS 102) 2015. The comments below focus on the FRS 102 SORP only, given the imminent mothballing of the FRSSE SORP along with the FRSSE regime.

In the FRS 102 SORP, going concern features as a fundamental accounting principle in Module 3 - rather clumsily entitled “Accounting standards, policies, concepts and principles including the adjustment of estimates and errors”. In paragraph 3.14, the SORP reminds us that “charities normally prepare their accounts on the basis of being a going concern”. Interestingly, in my view, the SORP does not offer a definition of “going concern” in its glossary so it will be up to Trustees and management to seek this out independently, no doubt with guidance from the charity’s auditors or examiners, and with reference to the definitions discussed earlier in this article.

SORP Module 3 then goes on to re-iterate that the Trustees “must make their own assessment of their charity’s ability to continue as a going concern to assure themselves of the validity of this assumption when preparing their accounts”. In line with the presumptions underpinning UK GAAP, the SORP emphasises that “In making this assessment, a charity’s trustees should take into account all available information about the future for at least, but not limited to, 12 months from the date the accounts are approved”.

Herein lies a challenge for charity Trustees. Whilst the general FRS 102 guidance refers to the responsibilities of “management” to undertake the going concern assessment, the SORP is clearly placing this responsibility on the Trustees. This is also in line with the requirements of ISA 570 which clarifies throughout through the use of footnotes that in the UK and Ireland it is “those charged with governance” who are responsible for
the preparation of the financial statements and therefore the assessment of the entity’s ability to continue as a going concern. In practice, however, charity Trustees will need to interpret and place significant reliance on the information and assumptions prepared by the charity’s staff, or suitably experienced volunteers in the absence of any paid staff.

Furthermore, the Trustees’ assessment of the charity’s ability to continue as a going concern involves a judgement, at a particular point in time, about inherently uncertain future outcomes of events or conditions. Most of us would agree that – for charities – these uncertainties are likely to be even more acute given the current socio-economic, fiscal and political factors affecting the sector.

**Whose responsibility?**

Guidance on going concern, whether in FRS 102, the Charities SORP or the ISA makes it clear that it is the responsibility of management (in the case of a charity, the charity’s Trustees) to make an assessment of the entity’s ability to continue as a going concern. This is integral to the preparation of the accounts, which is a key responsibility of the Trustees even if the mechanical process is delegated to staff or a third party. It is a bullet point that has long been enshrined in the Trustees’ Responsibilities paragraphs in the Trustees’ Report (often rolled over from one year to the next, but that mustn’t diminish their importance) and which confirms that the Trustees are responsible for preparing the accounts on the going concern basis unless it is inappropriate to assume that the charity will continue to operate.

So what role does the auditor have? In short, the auditor’s responsibility is to evaluate management’s or, in the case of charities, the Trustees’ assessment of the entity’s ability to continue as a going concern. As ISA 570 makes clear, “the auditor’s responsibility is to obtain sufficient appropriate audit evidence about the appropriateness of [the Trustees’] use of the going concern assumption in the preparation and presentation of the financial statements”. The timescales for this exercise should start right at the beginning of the accounts preparation stage, if not before, as the auditor is required to make a preliminary assessment of the appropriateness of the going concern basis as part of their overall risk assessment at the audit planning stage.

Indeed, this is just the start. As well as considering whether the Trustees’ assessment includes all relevant information of which the auditor is aware during the audit, the auditor must “remain alert” for any additional evidence of events or conditions that may cast significant doubt on the charity’s ability to continue as a going concern. Therefore, this is clearly an iterative and proactive process which involves the Trustees and the auditor, and which draws on positive evidence to support the status quo whilst being alert for events or conditions which might threaten that status quo.

Crucially, it is also a process which has to be kept under review right up until the date of signing and even then it still requires an element of prediction in respect of a further 12 months minimum. There are a number of inherent challenges here. Whilst we have certain tools, information and lines of enquiry at our disposal, neither the Trustees nor the auditor can predict all of the future events or conditions which may cause an entity to cease to continue as a going concern, a fact which is even acknowledged in the ISA. Furthermore, uncertainty about whether...
a charity is a going concern may well arise because it is inextricably linked to a decision which is in the hands of a third party, such as a bank or a funder. This may protract the process such that the accounts signing date is delayed, in which case the going concern assessment timescales will also become a moving target. It could also be that the very decision itself is fundamental to the charity’s going concern assumption, thus creating a somewhat circular and potentially self-fulfilling scenario.

It is worth noting here that if the Trustees are not willing to update their assessment to cover the requisite minimum 12 month timeframe this will require the auditor to “consider the implications for his report”.

Special factors affecting charities

In considering factors relating to a charity’s status as a going concern, Trustees and the auditors will inevitably need to take account of the particular circumstances of the charity and the wider sector in which it is operating. Central to this will undoubtedly be consideration of the availability and nature of current and future funding (including the role and extent of restricted funds) and of the charity’s purpose. Some charitable activities are focused on a specific purpose, and once this is achieved, the charity may legitimately cease to operate. It is also important to acknowledge that one of the most significant factors ensuring the future viability of many charities is public goodwill. However, it is difficult, if not impossible, to value this. Even if it was possible, it is not a value which is permitted on the balance sheet – and nor can the Trustees or the auditor rely solely on the existence of goodwill as evidence to support the going concern assumption.

It should also be noted that the auditor has no duty to assess whether the charity’s activities are for the public benefit in order to establish that the charity is a going concern. However, persistent failure by a charity to meet its public benefit requirement may have an implication for the Trustees’ - and therefore the auditor’s - assessment of going concern.

Also worth highlighting is the situation in a charitable group where the going concern basis is dependent upon the provision of support (usually financial) from one group entity to another. The going concern assessment must take into account the extent to which such support is permissible within the charitable objects and powers, and ensure that there is ultimately enough independent evidence to show that the entity being relied upon to support the others is itself a going concern.

Further useful information regarding the special factors pertinent to the going concern assessment of charities is included in The Auditing Practice’s Board Practice Note 11 (Revised) on The Audit of Charities in the United Kingdom. Whilst this guidance is aimed primarily at charity auditors it also provides a useful perspective on this topic for charity Trustees.


Concerns with going concern?

FRS 102 and the FRS 102 Charities SORP are both very clear that factors which cast doubt on the appropriateness of the going concern assumption must be disclosed. Herein lies another quandary for charities which find themselves in that position. Issues can arise when trying to balance transparent and robust reporting, with the chain of events that is likely to ensue from making honest disclosures about going concern doubts. All too often, events can spiral into a self-fulfilling prophecy. However, the SORP explains what charities must (or should) do in Module 3, paragraph 3.38:

“All charities must explain if there are material uncertainties related to events or conditions that cast significant doubt on the charity’s ability to continue as a going concern.”
The use of the word “must” here underlines this as a seemingly non-negotiable requirement and no doubt will instigate some interesting debates with the auditor about what is a “material uncertainty” or what would constitute “significant doubt”. Interestingly, in my view, the same SORP paragraph then relaxes its requirements by saying that in making this explanation, “charities should provide:

- a brief explanation as to those factors that support the conclusion that the charity is a going concern; and
- a balanced, proportionate and clear disclosure of any uncertainties that make the going concern assumption doubtful.”

It then confirms that, on the other hand, “if the accounts are not prepared on a going concern basis, this fact must be disclosed, together with the basis on which the Trustees prepared the accounts and the reason why the charity is not regarded as a going concern”.

These disclosures are in line with those required in FRS 102 itself (paragraph 3.9) albeit with the term “shall” replacing should and must. The terms “must”, “should” and “may” are interwoven throughout the Charities SORP and as such are defined in its introduction in paragraphs 32 to 35. One can foresee that there will be some lively discussions between charity Trustees and the charity’s auditor in relation to the “musts” given that failure to comply with a “must” is likely to affect the ability of the accounts to give a true and fair view.

On a more positive note the Charities SORP in paragraph 3.39 states that “Where there are no material uncertainties about the charity’s ability to continue, this should be stated”. The SORP relaxes its requirements here – note the use of “should” not “must” for the confirmation of the inherent presumption of going concern.

Interestingly, the SORP does not say where these disclosures should be made but I would recommend that this information is disclosed prominently in the notes to the accounts.

It is also appropriate here, for completeness, to highlight the SORP’s requirements in relation to going concern disclosures in the Trustees’ Report which are applicable to all charities. In Module 1, paragraph 1.23, the SORP states that “If, at the date of approving the report and accounts, there are uncertainties about the charity’s ability to continue as a going concern, the nature of these uncertainties should be explained”. It could be concluded that there is some inconsistency here, given the use of the word “should” rather than “must”, suggesting that there is an element of wriggle room which is not available for the disclosures required by virtue of paragraph 3.38, above.

**What is a material uncertainty?**

The FRS 102 Charities SORP does not – as far as I can see – offer a definition of “material uncertainty” although the term “material” is defined in the glossary. Given the importance of this phrase in determining whether the going concern disclosures are adequate or – indeed – whether the auditor’s report is appropriate, this is somewhat surprising. ISA 570 assists, however, by explaining that “a material uncertainty exists [in relation to going concern] when the magnitude of its potential impact and likelihood of occurrence is such that, in the auditor’s judgement, appropriate disclosure of the nature and implications of the uncertainty is necessary for......the fair presentation of the financial statements, or......the financial statements not to be misleading.” The ISA also explains that the material uncertainty can exist in relation to events or conditions that - individually or collectively – may cast a significant doubt on the entity’s ability to continue as a going concern. These phrases introduce yet more judgement calls, and firmly place responsibility on the auditor to make them.

It may well be that the going concern basis is appropriate in the preparation of the charity’s
accounts, despite the existence of a material uncertainty. In this case the nature of the audit report will depend on the auditor’s view of the adequacy of the disclosures made by the Trustees in the financial statements. At best, an emphasis of matter will be included in the audit report which draws attention to the disclosures already made by the Trustees if these are deemed by the auditor to be adequate. It is important to note here that the audit report is still unmodified (i.e. not qualified, and still giving a true and fair opinion). If, however, the auditor considers that the disclosures in relation to the material uncertainty are not adequate, he will need to decide whether to issue a qualified or adverse audit opinion in line with the relevant ISA, together with further explanations in the audit report. In my experience, this type of report is rare in the charity sector as Trustees and auditors generally come to some agreement about the disclosures required before this course of action is necessary.

It almost goes without saying that the auditor has a duty to issue an adverse opinion if the financial statements have been prepared by the Trustees on a going concern basis but, in the auditor’s judgement, the charity is not a going concern thus deeming this basis inappropriate.

In conclusion

The going concern assessment by the Trustees, and the auditor’s assessment of that assessment, is likely to cause challenges from the start. Given the difficult economic environment in recent years, and little prospect of significant imminent improvement, charities and their auditors are having to be far more robust and proactive in their respective considerations. Going concern can be a very complex and sensitive area, particularly considering that there is a very real risk that honest disclosures can often create the outcome which they are only meant to be describing. Thrown into the mix is a plethora of judgements and interpretations by respective parties not only about individual events and conditions, but also about what might happen “collectively” - all over a timeframe which can also be a moving target and involve review and perhaps re-review. Early preparation, engagement, support, honesty and communication are key in this process – but even the most skilled and conscientious Trustees and auditors cannot predict the future!

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References and further guidance:

FRS 102 The Financial Reporting Standard applicable in the UK and the Republic of Ireland (September 2015)

Accounting and Reporting by Charities: Statement of Recommended Practice applicable to charities preparing their accounts in accordance with the Financial Reporting Standard applicable in the UK and the Republic of Ireland (FRS 102) (effective 1 January 2015) - Charities SORP (FRS 102)

International Standard on Auditing (UK and Ireland) 570 Going Concern

The Auditing Practice’s Board Practice Note 11 (Revised) on The Audit of Charities in the United Kingdom

Charity Commission guidance (Availalble at https://www.gov.uk/government/organisations/charity-commission/about/publication-scheme) including:

Internal Financial Controls for Charities (CC8)
The Hallmarks of an Effective Charity (CC10)
Managing Financial Difficulties and Insolvency in Charities (CC12)
Charities’ Reserves (CC19)
Charities and Risk Management (CC26)
Big Board Talk
Charity trustee meetings: 15 questions you should ask

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