

QUESTION THREE

(a)

Explain, with reference to the definition included within FRS 18, the meaning of the term “going concern”. Your answer should also discuss with reference to the work of the external auditor, what is meant by the term “foreseeable future”

(5 marks)

(b)

Carter Ltd (Carter) is a computer hardware specialist and has been trading for over five years. The company is funded partly through overdrafts and loans and also by several large shareholders; the year end is 30 April 2014.

Carter has experienced significant growth in previous years; however, in the current year a new competitor, Drums Design Ltd (Drums), has entered the market and through competitive pricing has gained considerable market share from Carter. One of Carter’s larger customers has stopped trading with them and has moved its business to Drums.

In addition, a number of Carter’s specialist developers have left the company and joined Drums. Carter has found it difficult to replace these employees due to the level of their skills and knowledge. Carter has just received notification that its main supplier who provides the company with specialist electrical equipment has ceased to trade.

Carter is looking to develop new products to differentiate itself from the rest of its competitors. It has approached its shareholders to finance this development; however, they declined to invest further in Carter. Carter’s loan is long term and it has met all repayments on time. The overdraft has increased significantly over the year and the directors have informed you that the overdraft facility is due for renewal next month, and they are confident it will be renewed.

The directors have produced a cash flow forecast which shows a significantly worsening position over the coming 12 months. They are confident with the new products being developed, and in light of their trading history of significant growth, believe it is unnecessary to make any disclosures in the financial statements regarding going concern.

At the year end, Carter received notification from one of its customers that the hardware installed by Carter for the customer’s online ordering system has not been operating correctly. As a result, the customer has lost significant revenue and has informed Carter that they intend to take legal action against them for loss of earnings. Carter has investigated the problem post year end and discovered that other work-in-progress is similarly affected and inventory should be written down. The finance director believes that as this misstatement was identified after the year end, it can be amended in the 2015 financial statements.

Requirement:

Describe and explain the potential indicators that Carter Ltd may not be a going concern.

(12 marks)

Describe the audit procedures which you should perform in assessing whether or not Carter Ltd is a going concern.

(8 marks)

QUESTION THREE

(a)

A business is defined as a going concern if it has the ability to continue in operational existence for the foreseeable future.

FRS 18 does not define the period of the foreseeable future.

When the directors considering the use of the going concern basis in the preparation of the financial statements, the length of FF is dependent on the entity's reporting and budgeting system and its nature, size + complexity

If period considered is less than 1 year, directors should consider whether any other disclosures are needed to explain the use of the going concern basis.

The auditor should consider if they concur with directors' judgement and the going concern basis is appropriate

(b)

Going concern indicators

A new competitor, Drums Design Ltd (Drums), has entered the market and gained considerable market share from Carter through competitive pricing. There is a risk that if Carter continues to lose market share this will impact on future cash flows.

In addition, there may be pressure on Carter to drop their prices in order to compete, which will impact profits and cash flows.

A significant customer has stopped trading with Carter and moved its business to Drums. This could result in a significant loss of future revenues and profit, and unless this customer can be replaced, there will be a reduction of future cash flows.

A number of Carter's specialist developers have left the company and joined Drums and the company has found it difficult to replace these employees due to their experience and skills. The company is looking to develop new products and in order to do this, it needs sufficiently trained staff. If it cannot recruit enough staff, then it could hold up the product development and stop the company from increasing revenue.

Carter's main supplier who provides specialist equipment has just stopped trading. If the equipment is highly specialised, there is a risk that Carter may not be able to obtain these products from other suppliers which would impact on their ability to trade. More likely, there

are other suppliers available but they may be more expensive which will increase the outflows of Carter and worsen the cash flow forecast.

Carter needs to raise finance to develop new products in order to gain market share; they approached their shareholders for further finance but they declined to invest further. If Carter is unable to obtain suitable finance, then it may be that the shareholders deem Carter to be too risky to invest in further. They may be concerned that Carter will not be able to offer them a suitable return on their investment, suggesting cash flow problems.

In addition, if Carter cannot obtain alternative finance, then it will not be able to develop the products it needs to.

Carter's overdraft has grown significantly during the year. If the bank does not renew the overdraft and the company is unable to obtain alternative finance, then it may not be able to continue to trade.

Carter's cash flow forecast shows a significantly worsening position for the coming 12 months. If the company continues to have cash outflows, then it will increase its overdraft further and will start to run out of available cash.

One of Carter's customers is planning to sue the company for loss of revenue due to hardware being installed by Carter in the customer's online ordering system not operating correctly. If the customer is successful, then Carter may have to pay a significant settlement which will put further pressure on cash flows.

In addition, it is unlikely that this customer will continue to trade with Carter and if the problems become known to other customers, this may lead to a further loss of revenue and cash flows as well as impact on Carter's reputation.

Going concern procedures

- Obtain the company's cash flow forecast and review the cash in and outflows. Assess the assumptions for reasonableness and discuss the findings with management to understand if the company will have sufficient cash flows.
- Perform a sensitivity analysis on the cash flows to understand the margin of safety the company has in terms of its net cash in/outflow.
- Discuss with the finance director whether any new customers have been obtained to replace the one lost.
- Review the company's post year-end sales and order book to assess if the levels of trade are likely to increase in light of the increased competition from Drum and if the revenue figures in the cash flow forecast are reasonable.
- Discuss with the directors whether replacement specialist developers have been recruited to replace those lost to Drum.
- Review any agreements with the bank to determine whether any covenants have been breached, especially in relation to the overdraft.

- Review any bank correspondence to assess the likelihood of the bank renewing the overdraft facility.
- Review the correspondence with shareholders to assess whether any of these are likely to reconsider increasing their investment in the company.
- Discuss with the directors whether they have contacted any banks for finance to help with the new product development.
- Enquire of the lawyers of Carter as to the existence of any additional litigation and request their assessment of the likelihood of Carter having to make payment to their customer who intends to sue for loss of revenue.

Perform audit tests in relation to subsequent events to identify any items which might indicate or mitigate the risk of going concern not being appropriate.

- Review the post year-end board minutes to identify any other issues which might indicate further financial difficulties for the company.
- Review post year-end management accounts to assess if in line with cash flow forecast.
- Obtain a written representation confirming the directors' view that Carter is a going concern.