

IFRS Viewpoint

Preparing financial statements when the going concern basis is not appropriate

What's the issue?

Both IAS 1 'Presentation of Financial Statements' and IAS 10 'Events after the Reporting Period' suggest that a departure from the going concern basis is required when specified circumstances exist. Neither Standard however provides any details of an alternative basis of preparation and how it may differ from the going concern basis. Entities will therefore need to develop an appropriate basis of preparation. This IFRS Viewpoint addresses some of the issues that entities will face when doing so.

Our 'IFRS Viewpoint' series provides insights from our global IFRS team on applying IFRSs in challenging situations. Each edition will focus on an area where the Standards have proved difficult to apply or lack guidance.

Relevant IFRS

IFRS 5 Non-current Assets Held for Sale and Discontinued Operations
IAS 1 Presentation of Financial Statements
IAS 10 Events after the Reporting Period
IAS 37 Provisions, Contingent Liabilities and Contingent Assets



Background

IAS 1 states “When preparing financial statements, management shall make an assessment of an entity’s ability to continue as a going concern. An entity shall prepare financial statements on a going concern basis unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so. When an entity does not prepare financial statements on a going concern basis, it shall disclose that fact, together with the basis on which it prepared the financial statements and the reason why the entity is not regarded as a going concern” (IAS 1.25).

IAS 1 appears then to suggest that a departure from the going concern basis is required when the specified circumstances exist.

This is confirmed by IAS 10 which states that “an entity shall not prepare its financial statements on a going concern basis if management determines after the reporting period date either that it intends to liquidate the entity or to cease trading, or that it has no realistic alternative but to do so.”(IAS 10.14).

Neither IAS 1 nor IAS 10 provide any details however of any alternative basis and how it might differ from the going concern basis. Management should then choose accounting policies that will result in the most relevant and reliable financial information.

Entities will therefore need to give careful consideration as to the appropriate basis of preparation bearing in mind their own specific circumstances. The purpose of this Viewpoint is not to provide guidance on determining whether an entity is or is not a going concern but to provide insights on the matters to be considered when a going concern basis is not appropriate.

Analysis

Objective of financial statements when not prepared on a going concern basis

Several points are relevant to the objective of financial statements that are not prepared on a going concern basis.

Firstly, there is no general dispensation from the measurement, recognition and disclosure requirements of IFRS if the entity is not expected to continue as a going concern. Our preference then is to use the 'normal' recognition and measurement requirements of IFRS as the starting point for accounting and only deviate from these where adequate justification exists, for example arising from events after the reporting date.

A second point is that each situation needs to be assessed on its own facts and circumstances as some entities in a non-going concern situation will be closer to liquidation or ceasing trading than others. The accounting will typically reflect this. For example, when an entity is in the process of being liquidated or will be liquidated imminently, the financial statements might be prepared under what is sometimes referred to as a 'break-up basis' or 'liquidation basis'.

Terminology

The terms 'break-up basis' and 'liquidation basis' are not defined terms that are used in IFRS but are ones that are used informally. 'Break-up basis' is used in some countries to signify that an entity is at a stage where its assets are being realised or are about to be realised as part of the process of liquidating the entity. In other countries the terms 'liquidation basis' or 'an orderly realisation basis' are used and are broadly equivalent in nature. An informative description of the preparation basis adopted will often be more important than the label attributed to it.

It is also worth noting that both IAS 1.25 and IAS 10.14 use the phrase 'cease trading'. This phrase is used in the sense of an entity which is no longer involved in the activity of buying and selling goods and services. It should not be confused with a situation where an entity which is listed on a stock exchange has its shares suspended from trading.

Some people argue that under such a 'break up' basis, the objective of the financial statements changes from reporting financial performance to consideration of matters such as:

- whether the assets are sufficient to satisfy the entity's creditors
- quantification of the amount of any surplus that may be available for distribution to the shareholders (ie what the value of the entity will be when it is 'broken up' into its separate parts on liquidation).

This is important as under such a 'break-up basis', provision would be made for losses subsequent to the reporting period and for the costs of winding up the business irrespective of whether an irrevocable decision to terminate the business had been made at the end of the reporting period. Assets would also be restated to their actual or estimated sale proceeds even if this was different from their fair value at the end of the reporting period.

Our view

The fact that a going concern basis is inappropriate does not automatically mean that a 'break-up' basis (see 'terminology' on page 3) is appropriate. In our view, the preparation of financial statements on this basis is not appropriate except perhaps in very rare circumstances. This is because the financial statements should reflect the circumstances existing at the end of the reporting period. For example, if the entity in question has assets that include quoted securities it is difficult to see why these should be recorded at an amount below their fair value even if they are sold for a lower amount after the reporting period. A loss on disposal in the subsequent period reflects the decision to hold them rather than to sell them at the end of the reporting period. For similar reasons, it would not be appropriate to make provision for future losses or liabilities for which there was no commitment at the end of the reporting period.

In this situation, our view is that even if a company has decided to cease trading, the financial statements should generally not be prepared on a break up basis but rather on a basis that is consistent with IFRS but amended to reflect the fact that the 'going concern' assumption is not appropriate. This will generally involve writing assets down to their recoverable amount¹ based on conditions existing at the end of the reporting period and providing for contractual commitments which may have become onerous as a consequence of the decision to liquidate the entity or to cease trading. We discuss these areas in more detail under the relevant headings below.

Measurement of assets

Writing down assets

It will always be appropriate to consider the need to write down assets for impairment when a company intends to liquidate the entity or to cease trading. For instance, when financial statements are prepared on a going concern basis, a non-financial asset may be stated at an amount which is greater than its net realisable value provided that it is no greater than its recoverable amount.

Our view

Where a decision has been made to cease trading in the near term, there are unlikely to be any material cash flows from the use of the asset other than from its disposal. Our view is that it will therefore often be necessary to write assets down to their fair value less costs of disposal in a non-going concern situation.

¹ Recoverable amount is defined in IAS 36 'Impairment of Assets' as "the higher of its fair value less costs of disposal and its value in use". 'Value in use' is defined as "the present value of the future cash flows expected to be derived from an asset or cash-generating unit".

Writing up assets

A related question is whether it is acceptable to write-up an asset where its fair value is greater than its carrying amount. A number of Standards would not permit such a write-up as their requirements restrict the amount to be recognised for an asset to the lower of cost or depreciated cost and net realisable value/fair value less costs to sell. These include IAS 2 ‘Inventories’, the cost model under IAS 16 ‘Property, Plant and Equipment’ and IFRS 5 ‘Non-current Assets Held for Sale and Discontinued Operations’.

Our view

Our view is that it will generally be inappropriate to make such upward adjustments as there is no general dispensation from the measurement, recognition and disclosure requirements of IFRS if the entity is not expected to continue as a going concern.

However, in those situations where an entity deems it appropriate to prepare its accounts on a ‘break up basis’ (see above), it is difficult to definitively rule out such adjustments given the lack of clarity in IAS 1 and IAS 10 in relation to financial statements that are not prepared on a going concern basis. Where such an approach is adopted, however, clear disclosure will be key (see separate section).

Liabilities

Contractual commitments may become onerous because of a decision to cease trading or to liquidate a business.

Our view

Our view is that it may be acceptable to accrue such costs by applying the guidance on onerous contracts in IAS 37 ‘Provisions, Contingent Liabilities and Contingent Assets’ by analogy. As stated above there is no general dispensation from the measurement, recognition and disclosure requirements of IFRS if the entity is not expected to continue as a going concern. We therefore believe that it will generally not be appropriate to make a provision for future losses or liabilities for which a commitment did not exist at the end of the reporting period. We consider our views here to be consistent with IAS 37’s guidance that provisions for future operating losses are not recognised (IAS 37.63).

Other complex issues may be encountered. For example, take the case of financial liabilities that are legally payable on demand but which will not be paid in full due to a lack of available resources. IFRS 13 ‘Fair Value Measurement’ requires the fair value of a financial liability with a demand feature to be not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid. The question is whether adjustments can be made to such liabilities to take into account the fact that they will not be paid in full where an entity prepares its financial statements on a basis other than going concern.

Our view

Our view is that it will generally not be appropriate to make such adjustments. However, similar to the issue of writing up assets, it is difficult to definitively rule out these adjustments where an entity prepares its financial statements on a ‘break up basis’ given the lack of clarity in IAS 1 and IAS 10.

“It will always be appropriate to consider the need to write down assets for impairment when a company intends to liquidate the entity or to cease trading.”

Presentation and disclosure

Given the lack of guidance under IFRS where an entity does not prepare its financial statements on a going concern basis, clear presentation and disclosure of the accounting adopted will be key. We discuss some of the major issues arising under the following headings:

- reclassification of assets and liabilities from non-current to current
- presentation of discontinued operations
- IFRS compliance
- disclosure.

Reclassification of assets and liabilities from non-current to current

An issue to consider when a going concern basis is not appropriate is whether non-current assets should be reclassified as current assets and non-current liabilities reclassified as current liabilities.

Our view

Our view is that assets classified as non-current in accordance with IAS 1 should not be reclassified as current assets unless and until they meet the 'held for sale' criteria in IFRS 5. However, non-current liabilities may have to be reclassified as current liabilities because of breaches of borrowing covenants and similar factors which existed at the end of the reporting period. Entities may also need to consider reclassifying financial instruments they have issued from equity to liabilities where those instruments contain terms that require the entity to settle the obligation in cash or another financial asset in the event of liquidation of the entity (such terms are ignored under IAS 32.25(b) where an entity is a going concern).

Presentation of discontinued operations

Another issue that arises is whether an entity needs to present discontinued operations in accordance with IFRS 5 when a going concern basis is not applicable as the result of, for example, an intention to cease trading.

Our view

While differing views may exist on this issue, our preference is not to insist on presentation of discontinued operations in such a situation. Our view is that the objective of presenting discontinued operations as a separate item of income or loss is to segregate the results that have been discontinued from the results of continuing operations. We believe that this would not result in meaningful information in a situation where an entity has decided to cease trading and all of its operations will therefore be discontinued.

IFRS compliance

Mixed views exist as to whether an entity can claim compliance with IFRS if its financial statements are not prepared on a going concern basis. Some commentators struggle to see financial statements as being IFRS compliant when they depart from the normal measurement requirements of IFRS. For example, can an entity be considered as applying an IFRS framework when using alternative non-going concern accounting policies (eg liquidation values)? Similarly, if going concern is not an appropriate assumption for the basis of preparation, what is the appropriate basis – should it start with IFRSs and be modified on an individual item basis or does it override all IFRSs?

Our view

Our view is that the lack of guidance in IFRS means that it is difficult to definitively say what can or cannot be done provided that an entity adopts a basis that is supportable and well disclosed. As discussed earlier, we also believe that it is acceptable to use the ‘normal’ recognition and measurement requirements of IFRS as the starting point for accounting and deviate from these where adequate justification exists. Provided such an approach is taken, we believe it is acceptable to make an explicit and unreserved statement of compliance with IFRSs in the financial statements.

Disclosure

Finally, it is important to remember that IAS 1 requires disclosure of the judgements made in applying the entity’s accounting policies that have the most significant effect on the amounts recognised in the financial statements. It will of course then be very important to adequately disclose the basis of preparation and its effects in a situation where an entity prepares its financial statements on a basis other than going concern. Such disclosure might cover:

- the nature of any departure from the ‘normal’ recognition and measurement requirements of IFRS
- the nature of any reclassifications of assets or liabilities from non-current to current
- qualitative and/or quantitative information on write-ups or write-downs of assets
- key assumptions and judgements made by management
- the effect on comparatives.

Whether statutory financial statements will be required at all will depend on the legal and regulatory requirements in the jurisdiction concerned.



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