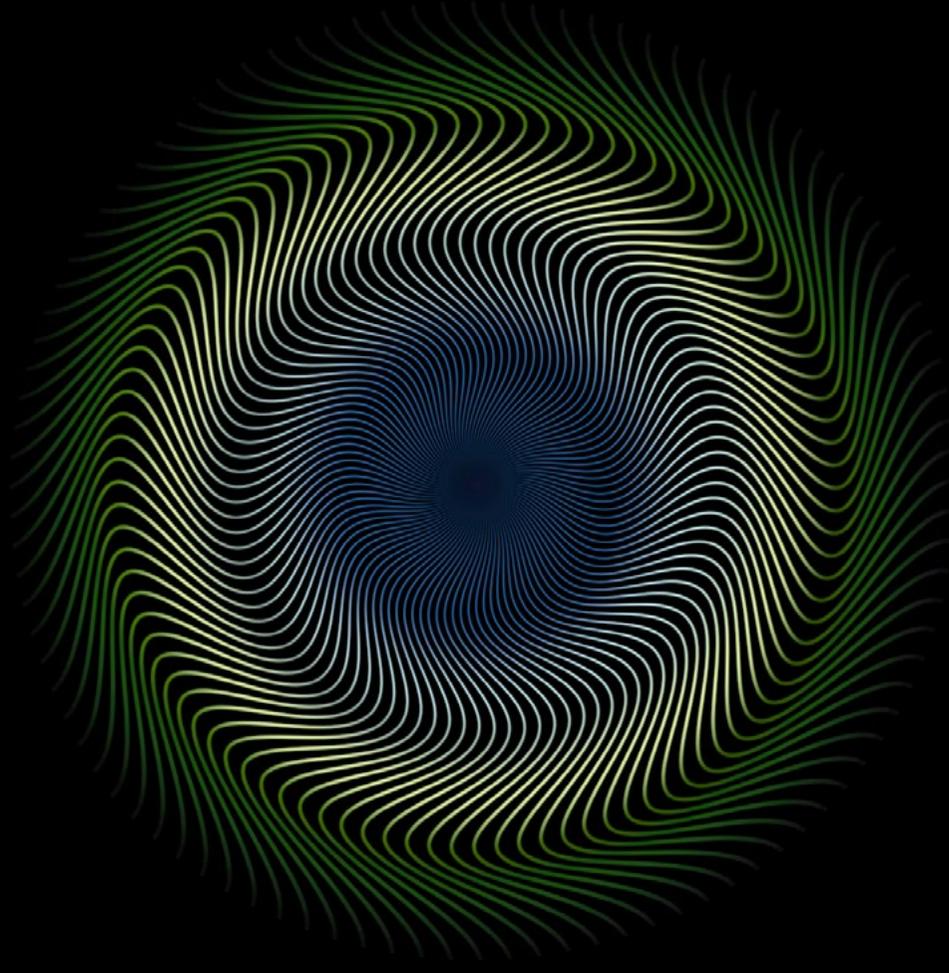


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**What is the impact of COVID-19 on your
going concern assessment?**

July 2020

What is the impact of COVID-19 on your going concern assessment?

In the face of continuing uncertainty around the progress of COVID-19 and what a recovery may look like, directors of many organisations are concerned about how their companies, registered schemes or disclosing entities (“the entity” or “entities”) will be affected in the short and medium term and what their obligations are under the *Corporations Act 2001* in relation to going concern.

WHY IS THIS SO IMPORTANT?

Compliance with directors’ legal obligations

Directors have obligations in relation to both solvency and going concern which differ. Solvency is the entity’s ability to pay its debts as and when they become due and payable. Going concern contemplates whether a business can reasonably continue operating for the upcoming 12 months. This paper focuses on going concern however to aid directors we’ve included a refresher on solvency.

Solvency

For entities within the scope of the *Corporations Act 2001*, directors are required at least annually (and half-yearly where required) to make a declaration of solvency. This declaration states that in the directors’ opinion “there are reasonable grounds to believe that the entity will be able to pay its debts as and when they become due and payable”. When making this declaration, directors must consider the capacity of the entity to pay debts that it has incurred at the time of the declaration.

While the declaration of solvency is made at a point in time, the directors have an obligation to assess solvency throughout the year. Depending on the outcome of the assessment by the directors (which is based on the reasonable grounds on which they made that assessment), the Directors’ Declaration in respect of solvency may be that:

- the directors have reasonable grounds to believe that the entity will be able to pay its debts as and when they become due and payable (positive declaration),
- there is a material uncertainty as to the entity’s ability to pay its debts as and when they become due and payable – for example, the ability to renegotiate loans due for repayment is not certain at the date of the declaration and without this being achieved the entity will not be able to pay its debts as and when they become due and payable, or
- The directors do not have reasonable grounds to believe that the entity will be able to pay its debts as and when they become due and payable (negative declaration). ➔

Refer to guidance in [Regulatory Guide 22 Directors’ Statements as to Solvency \(RG 22\)](#), ASIC’s COVID-19 FAQs and <https://aicd.companydirectors.com.au/membership/membership-update/insolvent-trading>



Going concern

In addition to their responsibilities in respect of solvency, management and directors have an obligation in relation to going concern that arises under Section 296 of the *Corporations Act 2001*, which requires companies to comply with accounting standards. Accounting standards require management to make an assessment of an entity's ability to continue as a going concern and prepare financial statements on a going concern basis, unless management either intends to liquidate the entity, to cease trading or has no realistic alternative but to do so.

Management and directors are required to reach a view on going concern taking into account all available information about the future for a period which is at least, but is not limited to, 12 months from the end of the reporting period.

In the current environment reaching a view on that minimum 12 month horizon will be more challenging for many organisations and there is heightened risk that organisations could fail over the short and medium term. Accordingly, focus on whether an entity is a going concern should be heightened.

Robust and well documented assessment, using the best information available at the time, is critical should issues emerge in the period post issue of the financial statements.

Financial modelling, including reverse stress test scenarios to identify the period that an entity can continue to operate under worst case scenarios, and how much it would take to exhaust cash (including available facilities) and/or breach covenants, will be a critical step in the directors' assessment of going concern. Globally, we have seen many organisations preparing multiple scenarios relating to cash flows for the Board's consideration to reflect the uncertainty and range of possible outcomes in the current economic environment.

Downward asset valuations or revenues may also trigger legal and compliance issues or lead to liquidity challenges and/or business resilience concerns. Directors should ensure management prepare papers which set out the supporting evidence for the fair value or carrying value of assets and whether they are impaired. ➔

What factors contribute to a robust going concern assessment?

In reaching a view on going concern, management and directors should consider the impact of COVID-19 on the entity's business model and operations, including, but not limited to:

- Overall changes in economic and market conditions
- Significant drops in demand and/or a reduced customer base
- Risks of failure in the supply chain including logistical and financial
- Limited distribution channels for goods and services
- Changes in government support to businesses and the community
- Restricted ability to operate due to changes in public policy
- Geographical implications and country risk relating to group operations and impacts on markets in which goods and services are sold/ sourced
- The interdependence of group operations, access to IT systems, supply and distribution, dependence on licences and other intellectual property and funding

The economic impacts of the above on the entity's business model are likely to impact on the need to assess the entity's liquidity analysis including, but not limited to:

- Assessment of cash flow beyond EBITDA – inclusion of interest payments, lease and loan amortisation payments, capital expenditure and committed expenditure
- Funding restrictions (potential constraints on available facilities lines of credit), liquidity of lenders and covenant compliance; level and exposure of funding guarantees
- Cash balances (net); impacts of supplier credit terms and debtor payment cycles; the level of precision in the timing of cash flows used in forecasts and sensitivities applied
- Working capital management and assumptions
- Formulation of contingency plans including dependencies
- Uncertainties relating to the above
- Consideration of the reasonableness of the basis and the support for the assumptions made in respect of the above

What is the impact of COVID-19 on your going concern assessment?

Where there are material uncertainties around whether a business can continue as a going concern, these need to be disclosed in the financial statements to enable users to understand those material uncertainties and proposed actions to manage them.

Auditors have an obligation to obtain sufficient appropriate audit evidence supporting management's assessment of whether the entity can continue as a going concern and evaluate management's conclusion in respect of the going concern basis. The auditor's obligation is slightly different as the requirement is from a minimum 12 months from the date of signing of the financial report and therefore the auditor is required in accordance with auditing standards to request management to extend its assessment period to correspond with the auditor's required period. Accordingly, the auditor must evaluate a longer period than the entity is required to consider under accounting standards and the *Corporations Act 2001* but, through the interaction with auditing standards, the periods should align. There are a range of potential audit report outcomes deriving from disclosures, or lack thereof, relating to going concern in the financial statements, including, no modification to the opinion, highlighting of the material uncertainty relating to going concern disclosures in the financial statements or potentially a qualification of disclaimer of opinion.

A qualification would generally occur if the auditor concludes there were material uncertainties as to whether the entity can continue as a going concern and these uncertainties have not been disclosed appropriately or, where the auditor disagrees with management's assessment that the entity is a going concern. ➔

Questions to consider

The challenges and opportunities that each entity is working through are very different and accordingly the questions that need to be answered for each entity will vary. The questions below represent common governance questions that directors could ask on this topic but are not a complete list for each entity due to sectorial, geographical, organisational, business model, ownership and funding differences between entities.

Directors should consider:



DEPTH OF ANALYSIS

- Is the analysis performed by management sufficiently detailed and is it based on a robust assessment of the operating and financial exposures arising from COVID-19 that the entity has been or may be impacted by, to enable directors to reach an informed view on whether the entity can continue as a going concern for 12 months from the date of signing the financial report?
- Is the robustness of the assumptions supporting the cash flow forecasting reasonable and defensible?



A RANGE OF SCENARIOS

- Does the going concern analysis effectively combine available cash with a range of scenarios including a reasonable worst-case scenario to allow directors to conclude on the going concern assessment?



INTERNAL MODELLING CONSISTENCY

- Where appropriate, are cashflow estimates used in the going concern analysis consistent with those used (after adjusting for certain differences under the accounting standards) for establishing or supporting balance sheet values (e.g. impairment and deferred tax)?
- Are the key assumptions underlying the cash flows supportable and reasonable?



EXTERNAL DISCLOSURE CONSISTENCY

- Is the analysis consistent with recent market disclosure including Directors' Reports and Investor presentations?



LIQUIDITY AND FUNDING

- Have solvency and going concern assessments been performed as at the date of signing the Directors' Declaration?
- Does the analysis reasonably consider the entity's access to funding and ability to navigate covenant compliance?
- Does the analysis incorporate applicable loan guarantees?
- Has the dependence on government assistance or grants and the relevant conditions relating to their availability or termination been assessed?
- Is there sufficient liquidity over an extended period of time against a robust reforecast of trading results and cashflow forecasts?
- Are the directors across the extent of management's discussions with financiers, in particular in situations where waivers have been obtained or are being sought from financiers for forecast covenant breaches?



GOING CONCERN BASIS ADOPTION

- Does analysis suggest that, on balance, it is reasonable to conclude that the entity has the ability to continue as a going concern?



DOCUMENTATION

- Is the board analysis and challenge of management's analysis supporting the assessment of the going concern basis appropriately documented as evidence of that challenge?



DISCLOSURE WHEN NO MATERIAL UNCERTAINTIES EXIST

- Has the entity made explicit disclosure on their position that it is appropriate to conclude that the entity can continue to operate as a going concern?
- Do the financial statements disclose the rationale for this conclusion including where the financial statements indicate (based on other disclosures within the financial statements / report) that there may be uncertainties?



DISCLOSURE WHEN MATERIAL UNCERTAINTIES EXIST

- Has the entity made explicit disclosure on their position that there are material uncertainties as to whether the entity can continue to operate as a going concern?
- Do disclosures detail the events or conditions that indicate there is an uncertainty either at or post balance sheet date?
- Do disclosures detail management's plans or options available to them, either within or outside their control, to mitigate the effect of the events or conditions, the status of any plans and the interdependency of these plans or options?
- Do disclosures detail why management believes the plans are feasible or have a reasonable basis?
- Do disclosures detail the factors necessary for the entity to be able to continue as a going concern?
- Do disclosures include other relevant information, such as interface with contingent liabilities?

Final thought

The impact of COVID-19 on the global economy and financial markets is expected to continue to evolve and there is a wide range of impacts and outcomes entities will experience. In the face of certain challenges and uncertainty, the Board should act as the ultimate stewardship body of the entity, guiding and supporting management in its decision making. It is essential that directors are mindful of what they do to fulfil their obligations under the *Corporations Act 2001*, as it relates to the going concern assessment of the entity. It is these actions and the documentation and disclosure of these that demonstrates the obligations have been executed effectively.

The assessment of going concern is inherently complex and requires significant judgment to take an informed view of the business going forward. This publication provides general guidance of questions for directors and management to consider and does not set out all requirements that need to be fulfilled. Based on entity specific circumstances directors or management may consider whether legal advice is warranted to ensure that they have considered all their responsibilities in relation to the assessment and related disclosures. Directors should also refer to ASIC's Frequently Asked Questions issued in relation to the impact of COVID-19 on financial reports and audits.

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