Grant Thornton
An instinct for growth™

MFRS Hot Topics

Preparing financial statements when the going concern basis is not appropriate

December 2017

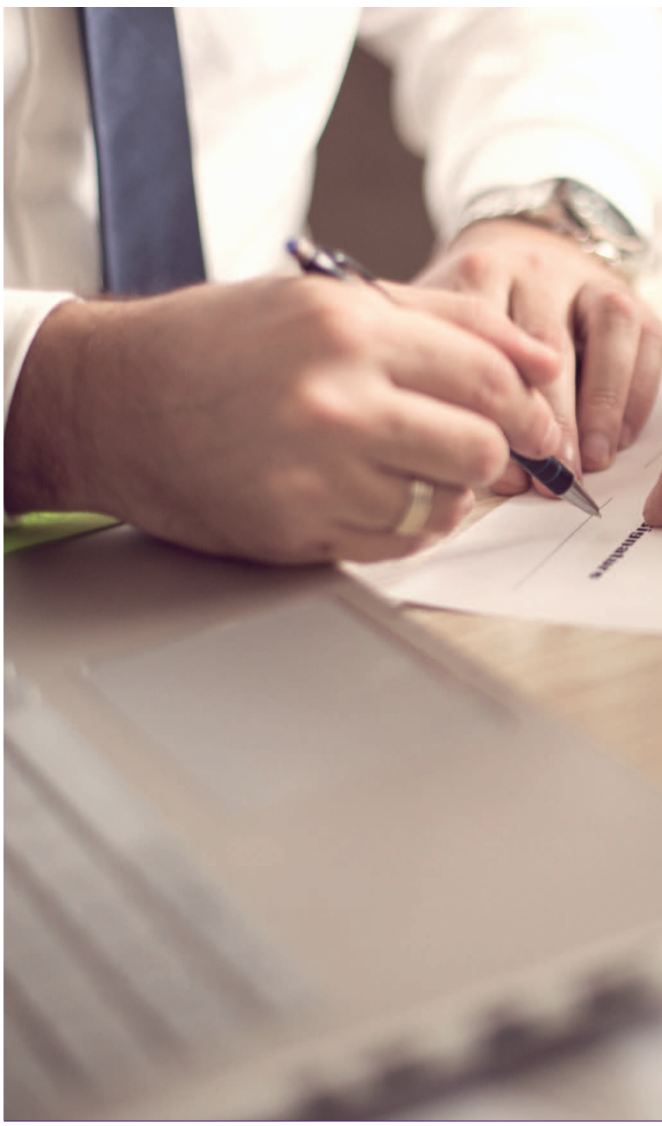
Audit | Tax | Advisory

Contents

Issue

This edition of MFRS Hot Topics provides guidance on the issues encountered when an entity determines that it is not appropriate to prepare its financial statements on a going concern basis.

Relevant MFRSs
MFRS 5 Non-current Assets Held for Sale and Discontinued Operations
MFRS 101 Presentation of Financial Statements
MFRS 110 Events after the Reporting Period
MFRS 137 Provisions, Contingent Liabilities and Contingent Assets



What's the issue?

Both MFRS 101 'Presentation of Financial Statements' and MFRS 110 '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 MFRS Hot Topics addresses some of the issues that entities will face when doing so.

Background

MFRS 101 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" (MFRS 101.25).

MFRS 101 appears then to suggest that a departure from the going concern basis is required when the specified circumstances exist.

This is confirmed by MFRS 110 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."(MFRS 110.14).

Neither MFRS 101 nor MFRS 110 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 MFRS Hot Topics 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 MFRS 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 MFRS 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'.

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 (i.e. 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.

Terminology

The terms 'break-up basis' and 'liquidation basis' are not defined terms that are used in MFRS 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 MFRS 101.25 and MFRS 110.14 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.

Our view

The fact that a going concern basis is inappropriate does not automatically mean that a 'break-up' basis (see 'terminology' on page 4) 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 MFRS but amended to reflect the fact that the 'going concern' assumption is not appropriate. This will generally involve writing assets down to their recoverable amount[1] 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.

[1] Recoverable amount is defined in MFRS 136 '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".

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.

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 MFRS 102 'Inventories', the cost model under MFRS 116 'Property, Plant and Equipment' and MFRS 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 MFRS 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 MFRS 101 and MFRS 110 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 MFRS 137 'Provisions, Contingent Liabilities and Contingent Assets' by analogy. As stated above there is no general dispensation from the measurement, recognition and disclosure requirements of MFRS 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 MFRS 137's guidance that provisions for future operating losses are not recognised (MFRS 137.63).

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. MFRS 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 MFRS 101 and MFRS 110.

Presentation and disclosure

Given the lack of guidance under MFRS 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
- MFRS 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 MFRS 101 should not be reclassified as current assets unless and until they meet the 'held for sale' criteria in MFRS 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 MFRS 132.25(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 MFRS 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.

MFRS compliance

Mixed views exist as to whether an entity can claim compliance with MFRS if its financial statements are not prepared on a going concern basis. Some commentators struggle to see financial statements as being MFRS compliant when they depart from the normal measurement requirements of MFRS. For example, can an entity be considered as applying an MFRS framework when using alternative non-going concern accounting policies (e.g. 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 MFRSs and be modified on an individual item basis or does it override all MFRSs?

Our view

Our view is that the lack of guidance in MFRS 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 MFRS 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 MFRSs in the financial statements.

Disclosure

Finally, it is important to remember that MFRS 101 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 MFRS
- 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.

How Grant Thornton can help

Grant Thornton is one of the world's leading organisations of independent assurance, tax and advisory firms. If you have any questions about MFRS, kindly be in touch with our team.

Our offices

Kuala Lumpur
Levels 11,15 & 8
Sheraton Imperial Court
Jalan Sultan Ismail
50250 Kuala Lumpur
T +603 2692 4022
F +603 2721 5229
E info@my.gt.com

Penang
51-8-A
Menara BHL Bank
Jalan Sultan Ahmad Shah
10500 Penang
T +604 228 7828
F +604 227 9828
E info.pg@my.gt.com

Johor
Unit 29-08, Level 29
Menara Landmark
12 Jalan Ngee Heng
80000 Johor Bahru, Johor
T +607 223 1848
F +607 224 9848
E info.jb@my.gt.com

Kuantan
A-105A, 1st Floor
Sri Dagangan, Jalan Tun Ismail
25000 Kuantan
Pahang
T +609 515 6124
F +609 515 6126
E info@my.gt.com

Cambodia
20th Floor, Canadia Tower
Monivong Boulevard
Phnom Penh
Cambodia
T +855 23 966 520
F +855 23 966 526
W www.grantthornton.com.kh

Grant Thornton

An instinct for growth™

grantthornton.com.my