

Course Book (2018 edition)

July 2018

Course Book, Chapter 5, Section 1.6 Accounting principles, 1.6.1 Going concern:

‘The Conceptual Framework states that this is a ‘fundamental assumption’.

The financial statements are normally prepared on the assumption that an entity is a going concern and will continue in operation for the foreseeable future. Hence, it is assumed that the entity has neither the intention nor the need to liquidate or curtail materially the scale of its operations; if such an intention or need exists, the financial statements may have to be prepared on a different basis and, if so, the basis used is disclosed.’

Preparing final accounts where the going concern concept applies

The going concern concept assumes that, when preparing a set of accounts, the business will continue to operate in approximately the same manner for the foreseeable future (at least the next 12 months). Consequently, where the going concern concept applies, the assets in final accounts will be shown as follows:

- Non-current assets are stated at carrying value (or held at revaluation as is studied in the Level 4 *Financial Statements* unit)
- Inventory is stated at the lower of cost and net realisable value
- Trade receivables are stated at the recoverable amount (generally the invoiced amount less any amounts that are irrecoverable or uncertain)

The main significance of the going concern concept is that the assets should **not** be valued at their ‘break-up’ value.

Preparing final accounts where the going concern concept does not apply (‘break-up value’)

In the final accounts of a business which is expected to cease trading, assets must be valued at their ‘break-up’ value (the amount they would sell for if they were sold off piecemeal and the business were broken up).

Why might a company no longer be considered to be a going concern?

Indications that an entity may no longer be a going concern include the following (from International Standard on Auditing, ISA 570 Going concern).

Financial indicators:

- Recurring operating losses per the statement of profit or loss
- A net liability per the statement of financial position
- Trade suppliers unwilling to supply to the business on credit
- Business is unable to pay interest due on loans or make loan repayments as they fall due for payment

Operational matters:

- Loss of key members of staff without replacement
- Emergence of a highly successful competitor

Other matters:

- Pending legal or regulatory proceedings against the entity,
- Changes in law or regulations that may adversely affect the entity

Illustration

A retail business has a year end of 31 December 20XX. At this date the business has the following assets:

Non-current assets	This is plant and machinery with a carrying amount of £5,000. If it had to be sold quickly, a buyer is expected to pay £1,000.
Inventory	At the year end the business has 30 washing machines for sale. They were purchased for £150 each and are usually sold for £250. In a forced sale, they are expected to raise £80 each.
Trade receivables	The business has trade receivables of £4,000 at the year end. However, some credit customers are slow payers and without the business's credit control function operating, they may not settle the amount due. Therefore, if the business were to wind down quickly it is likely that only £2,800 is recoverable from credit customers.

Requirement

Explain the way that assets would be valued in the year end final accounts on the assumption that:

- The owners intend to continue their business into the next year.
- The owners are forced to close down their business at the end of the year.

Solution

- If the business is regarded as a going concern:

Non-current assets	The plant and machinery will be shown at a carrying amount of £5,000.
Inventory	The washing machines will be shown at £4,500 (being 30 items x cost of £150 each). It is expected that their sale price will exceed cost, therefore they are not written down below cost price.
Trade receivables	The business has trade receivables of £4,000 at the year end. This amount will be net of irrecoverable/doubtful debts and therefore the full amount is expected to be recovered from credit customers.

(b) If the business is not regarded as a going concern:

Non-current assets	If the plant and machinery has to be sold quickly, a buyer is expected to pay £1,000.
Inventory	If the business is to be closed down the remaining machines must be valued at the amount they will realise in a forced sale, ie $30 \times £80 = £2,400$
Trade receivables	If business were to wind down quickly it is likely that only £2,800 is recoverable from credit customers. Therefore, £2,800 would be shown in the final accounts in respect of trade receivables.