

IAASB Staff-Prepared Briefing Paper – Clarification of the Concepts Relating to Going Concern in IFRSs

Background

1. The recent global financial crisis has highlighted the importance to financial markets of clear and timely financial reporting, and has resulted in a greater focus on the assessment of going concern and related disclosures. In the wake of the crisis, major policy debates have been initiated regarding the lessons that can be learned and the actions that can be taken with respect to going concern and liquidity risk issues that entities may be facing, including how the auditor might play a greater role in this regard.¹ The fact that going concern remains an especially critical financial reporting and auditing issue is underscored by the recent European Commission (EC) policy proposals regarding the statutory audit, a significant element of which is intended to enhance auditor reporting through the inclusion of an affirmative statement regarding going concern in the auditor's report for a public interest entity (PIE).² In addition, some respondents to the IAASB's May 2011 consultation³ asked for clarification of the respective roles and responsibilities of management and the auditor regarding going concern, and for auditors to report the outcome of their audit work regarding going concern. These developments provide a significant impetus for the IAASB to seek to enhance auditor reporting in this area.
2. In response to these developments, the IAASB intends to propose in its forthcoming consultation on auditor reporting⁴ that all auditors' reports be required to include:
 - (a) A conclusion regarding the appropriateness of management's use of the going concern assumption; and

¹ For example:

- In March 2011, the UK FRC launched an inquiry to identify lessons for companies and auditors addressing going concern and liquidity risks (the Sharman Inquiry) (see www.frc.org.uk/about/sharmaninquiry.cfm).
- In March 2012, the US PCAOB Investor Advisory Group (IAG) held discussions on the topic of going concern and related recommendations for possible actions by policy makers to enhance reporting by both companies and auditors regarding going concern (see pcaobus.org/News/Events/Pages/03282012_IAGMeeting.aspx).

² Under Article 22 of the EC's proposed regulation concerning audit reporting for PIEs, auditors would be required to provide "a statement on the situation of the audited entity or, in case of the statutory audit of consolidated financial statements, of the parent undertaking and the group, especially an assessment of the entity's or the parent undertaking's and group's ability to meet its/their obligation in the foreseeable future and therefore continue as a going concern." The EC's proposals can be accessed at http://ec.europa.eu/internal_market/auditing/reform/index_en.htm.

³ To explore options to enhance auditor reporting globally, the IAASB issued a consultation paper *Enhancing the Value of Auditor Reporting: Exploring Options for Change* in May 2011 (see http://www.ifac.org/sites/default/files/publications/exposure-drafts/CP_Auditor_Reporting-Final.pdf). The IAASB subsequently approved a project on auditor reporting in December 2011 (see http://www.ifac.org/sites/default/files/meetings/files/20111205-IAASB-Updated%20Agenda_Item_5-A-Auditor_%20Reporting_Project_Proposal-Approved_Clean_.pdf).

⁴ At its June 2012 meeting, the IAASB will be considering for approval an Invitation to Comment that will seek stakeholder input on a number of proposals to enhance the communicative value of auditor reporting (see http://www.ifac.org/sites/default/files/meetings/files/20120611-IAASB-Agenda_Item_3A-Auditor_Reporting_Draft_ITC-final.pdf).

- (b) A statement regarding whether, based on the audit work performed, material uncertainties have been identified related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.
3. To support this proposal, the IAASB believes that it may be necessary to provide additional guidance in the International Standards on Auditing (ISAs) regarding the nature of going concern and material uncertainties related to it. In this regard, the IAASB believes that, in developing and finalizing such guidance, it would be highly desirable to coordinate closely with the International Accounting Standards Board (IASB), given that the guidance on going concern in the ISAs (see Appendix 1) is closely interrelated with that in International Financial Reporting Standards (IFRSs) (see Appendix 2).

Matters for IASB Consideration

4. In considering how to clearly convey the outcome of the auditor's work on going concern in the auditor's report, the IAASB has identified three areas where it believes further guidance may be beneficial:
- (a) Are the criteria (or "threshold") for management's use of the going concern assumption the same as those for deeming the entity as being able to continue as a going concern?
 - (b) How should the term "significant doubt" be interpreted in relation to the concept of material uncertainty?
 - (c) What is management expected to disclose in relation to a material uncertainty?

Criteria for Use of the Going Concern Assumption and for Regarding the Entity as a Going Concern

5. IAS 1,⁵ paragraph 25, requires that when preparing the financial statements, management make an assessment of the entity's ability to continue as a going concern. It requires that the entity 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.
6. From this requirement, it is clear that use of the going concern basis of accounting (i.e., the going concern assumption) is appropriate only when the entity is not already in extreme financial distress (i.e., when the entity needs to liquidate or cease operations). This is also emphasized by the requirement in IAS 10,⁶ paragraph 14 (see Appendix 2). It is less clear whether *proximity to liquidation* is, or should be, the same threshold for the disclosure of material uncertainties relating to going concern.
7. A potential for differing views on this is created by the use of the phrase "ability to continue as a going concern" in the first sentence of paragraph 25 of IAS 1 in relation to the assessment that management is required to make, and in the description of a material uncertainty ("significant doubt upon the entity's ability to continue as a going concern"). It is unclear from the guidance in IAS 1 whether the "ability to continue as a going concern" is intended to simply mean that the entity will not need to liquidate or cease operations, or whether it more broadly means that the entity will be able to discharge its obligations as they become due in the normal course of business. There is a conceptual difference in that an entity that is facing significant difficulties in meeting its obligations

⁵ IAS 1, *Presentation of Financial Statements*

⁶ IAS 10, *Events after the Reporting Period*

as they become due may not be facing liquidation. For example, an entity that is unable to make its normal debt repayments may address this through debt rescheduling, raising additional equity capital by way of a rights issue, or selling part of its business.

8. Given that users are seeking timelier disclosures in relation to going concern, linking the disclosure of a material uncertainty to the broader concept of the entity's ability to discharge its obligations as they become due in the normal course of business would make information about such a material uncertainty public earlier than if the disclosure were linked to the entity's imminent liquidation.

Meaning of "Significant Doubt"

9. The disclosure of material uncertainties relating to going concern is important information for users. It is therefore very important that preparers and auditors understand the threshold for the disclosure of material uncertainties and apply it consistently.
10. IAS 1, paragraph 25, requires that when management is aware, in making its assessment, of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, the entity disclose those uncertainties. IAS 1, however, does not define the concept of material uncertainty or provide guidance to explain what it means.
11. The interaction of the terms "material," "may," and "significant" make this a very complex concept and can lead to confusion in practice.
12. An uncertainty about whether an entity will be able to continue as a going concern will likely always be material to users. For example, from a capital markets perspective, even a slight perception of a risk of a going concern issue can have a material impact on bond yields or the interest rate charged by other creditors (e.g., banks) to the entity. Arguably, it is the *likelihood* of the occurrence of the event or condition that will give rise to the existence of the need for disclosures.
13. In addition, the word "may" in a probabilistic sense means "possible," which implies a very low threshold for identifying when events or conditions "may" cast significant doubt. On the other hand, the use of the word "significant" implies a high threshold.

Disclosure of Material Uncertainties

14. Paragraph 25 of IAS 1 requires that when management is aware, in making its assessment, of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, the entity disclose those uncertainties. There is no guidance as to what management is in fact expected to disclose. In particular, it is unclear whether management is expected to disclose the nature of the event or condition, the severity of the issue, the likelihood of its occurrence, or the likely effect of mitigating circumstances, including management actions to address the issue.

Appendix 1

Relevant Requirements and Guidance in ISA 570⁷

2. Under the going concern assumption, an entity is viewed as continuing in business for the foreseeable future. General purpose financial statements are prepared on a going concern basis, unless management either intends to liquidate the entity or to cease operations, or has no realistic alternative but to do so. Special purpose financial statements may or may not be prepared in accordance with a financial reporting framework for which the going concern basis is relevant (for example, the going concern basis is not relevant for some financial statements prepared on a tax basis in particular jurisdictions). When the use of the going concern assumption is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business.
9. The objectives of the auditor are:
 - (a) To obtain sufficient appropriate audit evidence regarding the appropriateness of management's use of the going concern assumption in the preparation of the financial statements;
 - (b) To conclude, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern; and...
12. The auditor shall evaluate management's assessment of the entity's ability to continue as a going concern.
13. In evaluating management's assessment of the entity's ability to continue as a going concern, the auditor shall cover the same period as that used by management to make its assessment as required by the applicable financial reporting framework, or by law or regulation if it specifies a longer period. If management's assessment of the entity's ability to continue as a going concern covers less than twelve months from the date of the financial statements as defined in ISA 560,⁸ the auditor shall request management to extend its assessment period to at least twelve months from that date.
16. If events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern, the auditor shall obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists through performing additional audit procedures, including consideration of mitigating factors.
17. Based on the audit evidence obtained, the auditor shall conclude whether, in the auditor's judgment, a material uncertainty exists related to events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern. A material uncertainty exists when the magnitude of its potential impact and likelihood of occurrence is such that, in the auditor's judgment, appropriate disclosure of the nature and implications of the uncertainty is necessary for:

⁷ ISA 570, *Going Concern*

⁸ ISA 560, *Subsequent Events*, paragraph 5(a)

- (a) In the case of a fair presentation financial reporting framework, the fair presentation of the financial statements, or
- (b) In the case of a compliance framework, the financial statements not to be misleading.

Relevant Requirements and Guidance in IASs 1 and 10

IAS 1

25. **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 management is aware, in making its assessment, of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, the entity shall disclose those uncertainties. 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.**
26. In assessing whether the going concern assumption is appropriate, management takes into account all available information about the future, which is at least, but is not limited to, twelve months from the end of the reporting period. The degree of consideration depends on the facts in each case. When an entity has a history of profitable operations and ready access to financial resources, the entity may reach a conclusion that the going concern basis of accounting is appropriate without detailed analysis. In other cases, management may need to consider a wide range of factors relating to current and expected profitability, debt repayment schedules and potential sources of replacement financing before it can satisfy itself that the going concern basis is appropriate.

IAS 10

14. **An entity shall not prepare its financial statements on a going concern basis if management determines after the reporting period either that it intends to liquidate the entity or to cease trading, or that it has no realistic alternative but to do so.**
15. Deterioration in operating results and financial position after the reporting period may indicate a need to consider whether the going concern assumption is still appropriate. If the going concern assumption is no longer appropriate, the effect is so pervasive that this Standard requires a fundamental change in the basis of accounting, rather than an adjustment to the amounts recognised within the original basis of accounting.
16. IAS 1 specifies required disclosures if:
- (a) the financial statements are not prepared on a going concern basis; or
 - (b) management is aware of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern. The events or conditions requiring disclosure may arise after the reporting period.