ISA 570[1] – Potential Areas for Consideration

The following are extracts of ISA 570 to illustrate where Staff believes there may be a need for further consideration as described in **Agenda Item 9-C**. Particular parts of the extracts for further consideration have been highlighted, and commentary regarding possible avenues to pursue is provided in boxes. This paper has not been discussed in detail by the Task Force.

1. This International Standard on Auditing (ISA) deals with the auditor's responsibility in the audit of financial statements with respect to management's use of the going concern assumption in the preparation and presentation of the financial statements.

> Category A:[2] Contrary to the objectives of ISA 570, paragraph 1 does not appear to address the concept of material uncertainties that may exist related to events or conditions that may cast a significant doubt on an entities ability to continue as a going concern.

Going Concern Assumption

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 (e.g., 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.

> Category A: The last sentence is true in the context of the going concern basis of accounting. However, subject to International Accounting Standards Board (IASB) considerations, it may be more helpful to associate the phrase "the entity will be able to realize its assets and discharge its liabilities in the normal course of business" with material uncertainties rather than the going concern assumption.

Responsibilities of Management

3. Some financial reporting frameworks contain an explicit requirement for management to make a specific assessment of the entity's ability to continue as a going concern, and standards regarding matters to be considered and disclosures to be made in connection with going concern. For example, International Accounting Standard (IAS) 1 requires management to make an assessment of an entity's ability to continue as a going concern.[3] The detailed requirements regarding management's responsibility to assess the entity's ability to continue as a going concern and related financial statement disclosures may also be set out in law or regulation.

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[1] ISA 570, *Going Concern*

[2] The meaning of the categories is described in **Agenda Item 9-C**.

[3] IAS 1, *Presentation of Financial Statements*, as at 1 January 2007, paragraphs 23-24

> Category A: The highlighted sentence does not indicate that management also has a responsibility to disclose material uncertainties under International Financial Reporting Standards (IFRSs).

4. In other financial reporting frameworks, there may be no explicit requirement for management to make a specific assessment of the entity's ability to continue as a going concern. Nevertheless, since the going concern assumption is a fundamental principle in the preparation of financial statements as discussed in paragraph 2, management's responsibility for the preparation and presentation of the financial statements includes a responsibility to assess the entity's ability to continue as a going concern even if the financial reporting framework does not include an explicit requirement to do so.

> Category A: It may be helpful to indicate that disclosure of material uncertainties relating to going concern is also likely to be needed for the fair presentation of the financial statements and, for compliance frameworks, for the financial statements not to be misleading.

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:

    (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.

> Category B: This requirement and the associated guidance in paragraph A19 may need to be reconsidered and additional guidance given on the threshold for determining when a material uncertainty exists. More emphasis on the likelihood criterion may be appropriate as events or conditions that may affect the entity's ability to continue as a going concern will always likely have a high potential impact.

18. If the auditor concludes that the use of the going concern assumption is appropriate in the circumstances but a material uncertainty exists, the auditor shall determine whether the financial statements:

    (a) Adequately describe the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with these events or conditions; and

    (b) Disclose clearly that there is a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and, therefore, that it may be unable to realize its assets and discharge its liabilities in the normal course of business.

> Category C: The highlighted wording may need to be reconsidered. It is not required by IFRSs and therefore it is unclear as to whether or how it might fit with the ITC statements on going concern.

19. If adequate disclosure is made in the financial statements, the auditor shall express an unmodified opinion and include an Emphasis of Matter paragraph in the auditor's report to:

    (a) Highlight the existence of a material uncertainty relating to the event or condition that may cast significant doubt on the entity's ability to continue as a going concern; and to

    (b) Draw attention to the note in the financial statements that discloses the matters set out in paragraph 18. (See ISA 706.[4])

> Category C: Consequential changes may be needed to align with the concept of auditor commentary, subject to respondent views on question 9 in the ITC.

Communication with Those Charged with Governance

23. Unless all those charged with governance are involved in managing the entity, the auditor shall communicate with those charged with governance events or conditions identified that may cast significant doubt on the entity's ability to continue as a going concern. Such communication with those charged with governance shall include the following:

    (a) Whether the events or conditions constitute a material uncertainty;

    (b) Whether the use of the going concern assumption is appropriate in the preparation and presentation of the financial statements; and

    (c) The adequacy of related disclosures in the financial statements.

> Category C: This requirement may need to be reconsidered alongside changes to ISA 260[5] planned as part of the work on auditor reporting. ISA 570 requires communication of "*events or conditions* identified that may cast significant doubt on the entity's ability to continue as a going concern and additionally whether the events or conditions constitute a material uncertainty". IAS 1 refers (in the context of disclosures) to "*material uncertainties related to events or conditions* that may cast significant doubt …" This inconsistency in wording between ISA 570 and IAS 1 may lead to further confusion regarding what should be communicated, and at what level.

Events or Conditions That May Cast Doubt about Going Concern Assumption

A2. The following are examples of events or conditions that, individually or collectively, may cast significant doubt about the going concern assumption. This listing is not all-inclusive nor does the existence of one or more of the items always signify that a material uncertainty exists.

    Financial

    - Net liability or net current liability position.
    - Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.
    - Indications of withdrawal of financial support by creditors.

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[4] ISA 706, *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*

[5] ISA 260, *Communication with Those Charged with Governance*

- Negative operating cash flows indicated by historical or prospective financial statements.
- Adverse key financial ratios.
- Substantial operating losses or significant deterioration in the value of assets used to generate cash flows.
- Arrears or discontinuance of dividends.
- Inability to pay creditors on due dates.
- Inability to comply with the terms of loan agreements.
- Change from credit to cash-on-delivery transactions with suppliers.
- Inability to obtain financing for essential new product development or other essential investments.

Operating

- Management intentions to liquidate the entity or to cease operations.
- Loss of key management without replacement.
- Loss of a major market, key customer(s), franchise, license, or principal supplier(s).
- Labor difficulties.
- Shortages of important supplies.
- Emergence of a highly successful competitor.

Other

- Non-compliance with capital or other statutory requirements.
- Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy.
- Changes in law or regulation or government policy expected to adversely affect the entity.
- Uninsured or underinsured catastrophes when they occur.

The significance of such events or conditions often can be mitigated by other factors. For example, the effect of an entity being unable to make its normal debt repayments may be counter-balanced by management's plans to maintain adequate cash flows by alternative means, such as by disposing of assets, rescheduling loan repayments, or obtaining additional capital. Similarly, the loss of a principal supplier may be mitigated by the availability of a suitable alternative source of supply.

Category A: Depending on IASB considerations, this paragraph may need to be reconsidered. It may currently be perceived as implying that if there is the option of disposing of assets, rescheduling loan repayments, etc., then there is no material uncertainty that requires disclosure.

Audit Conclusions and Reporting

A19. The phrase "material uncertainty" is used in IAS 1 in discussing the uncertainties related to events or conditions which may cast significant doubt on the entity's ability to continue as a going concern that should be disclosed in the financial statements. In some other financial reporting frameworks the phrase "significant uncertainty" is used in similar circumstances.

Category B: This guidance may need to be expanded.