

July 2008

Basis for Conclusions: ISA 570 (Redrafted), Going Concern

*Prepared by the Staff of the International Auditing and
Assurance Standards Board*



**International Federation
of Accountants**

**BASIS FOR CONCLUSIONS:
ISA 570 (REDRAFTED), GOING CONCERN**

This Basis for Conclusions has been prepared by staff of the International Auditing and Assurance Standards Board (IAASB). It relates to, but does not form part of, ISA 570 (Redrafted), “Going Concern,” which was unanimously approved by the IAASB in March 2008.¹

Background

1. In September 2006, the IAASB agreed the conventions to be used in drafting future International Standards on Auditing (ISAs). These conventions are commonly referred to as the IAASB’s Clarity conventions.²
2. The IAASB has undertaken to redraft all of its ISAs in accordance with the Clarity conventions. This approach responds to the desire for all ISAs to be consistently drafted, and subject to a single statement of their authority and effect. The IAASB has agreed, in response to the general call for the Clarity project to be completed within a reasonable time, that while a significant number of the ISAs are under substantive revision as well as redrafting to reflect the new conventions, others will be subject to a limited redrafting to reflect only the conventions and matters of clarity generally. ISA 570 is in the latter category.
3. The IAASB issued an exposure draft of proposed ISA 570 (Redrafted) (ED-ISA 570) in February 2007, with a comment date of May 31, 2007. The IAASB received forty-five comment letters from a variety of respondents, including IFAC member bodies, national standard setters, firms, regulators, government organizations, and others. Input was also received from IFAC’s Small and Medium Practices Committee. The IAASB made changes to ED-ISA 570 in response to these comments. In addition, the IAASB discussed significant issues in the development of ED-ISA 570, and the finalization of ISA 570 (Redrafted), with its Consultative Advisory Group (CAG). The CAG raised no significant concerns about the proposed treatment of these issues with the IAASB.
4. This Basis for Conclusions explains the more significant issues raised by respondents on ED-ISA 570, and how the IAASB addressed them. In general, ED-ISA 570 received strong support from respondents in terms of how the extant ISA had been redrafted in accordance with IAASB’s Clarity conventions.

¹ See minutes of the March 10-14, 2008 IAASB meeting at <http://www.ifac.org/IAASB/Meeting-BGPapers.php?MID=0142>.

² The IAASB’s Clarity conventions, and the authority and obligation attaching to them, are established in the amended Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services (Preface). The amended Preface can be accessed at http://www.ifac.org/download/IAASB_Preface.pdf. Elements of the authority and obligation attaching to the Clarity conventions have been exposed as part of ISA 200 (Revised and Redrafted), “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing.”

Objectives

5. Paragraph 9 of ED-ISA 570 stated the following:

The objectives of the auditor are:

- (a) To obtain sufficient appropriate audit evidence about whether management's use of the going concern assumption in the preparation and presentation of the financial statements is appropriate in the circumstances; and
 - (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, if such a material uncertainty exists, to consider the implications for the auditor's report.
6. While the majority of respondents found the objectives to be appropriate, several respondents questioned the use of the phrase "obtaining sufficient appropriate audit evidence" within the objectives. These respondents contended that these words represent a substantive change of emphasis from the extant ISA 570, or imply a greater work effort than envisioned by the extant ISA. It was also questioned whether it is practicable to obtain sufficient appropriate audit evidence on the going concern assumption and whether the objective could be fulfilled by the requirements of the ISA. Concern was expressed that this may, among other things, create unreasonable expectations about the level of assurance the auditor obtains or can obtain in relation to going concern.
7. In addition, a few respondents found the proposed objectives needed to be more concise or were unclear about the substantive difference between the two objectives.
8. The IAASB deliberated these matters and concluded that, since the going concern assumption is a fundamental principle in the preparation of financial statements, it is appropriate for the auditor, in fulfilling the auditor's overall objective of obtaining reasonable assurance about whether the financial statements as a whole are free from material misstatement, to obtain sufficient appropriate audit evidence about whether management's use of the assumption is appropriate. Though the nature of the evidence that may be obtained for other subject matters may differ, the auditor's responsibilities remain the same. The IAASB considered the requirements of ISA 570 (Redrafted) in light of the objectives, and concluded that they establish reasonable expectations about the nature and extent of procedures needed to meet the objectives.
9. The IAASB also agreed that the form of the objectives appropriately reflects the two substantive elements of extant ISA 570 (Redrafted), being the need to address the appropriateness of the use of the going concern assumption, and whether events or conditions give rise to material uncertainty. The IAASB noted that if the objectives were too broad, they could result in being insufficiently precise to establish what is expected of the auditor. In addition, there could be a lack of linkage between the objectives and the requirements. Accordingly, the IAASB concluded that the objectives as proposed are appropriate and consistent with the substance of the extant ISA, that they express valid expected outcomes, and are consistent with how objectives in other ISAs are drafted.

10. Some respondents also commented that the objectives cover only situations when the going concern assumption is appropriate and a material uncertainty exists, and suggested that the objectives should cover reporting when the auditor concludes that the use of the going concern assumption is not appropriate. A few other respondents took the view that it would help readers if a clearer distinction were drawn in the objectives between the auditor's reporting responsibilities and the work effort required to support that reporting.
11. The IAASB agreed with these views, in that the auditor has a responsibility to determine the implication on the auditor's report in both situations where a material uncertainty exists related to events and conditions that may cast doubt on the entity's ability to continue as a going concern, and when the auditor concludes that management's use of the going concern assumption is inappropriate. Accordingly, the IAASB amended the objectives to make clear that one of the objectives of the auditor is to determine the implications for the auditor's report in both situations, as appropriate. See paragraph 9(c) of ISA 570 (Redrafted).

Material Uncertainty

12. Some respondents suggested the term "material uncertainty" should be defined in the ISA or that discussion thereof be amplified and included earlier in the ISA where the concept is first introduced. A few of these respondents also requested clarification on the relationship between the material on "material uncertainty" in paragraph 17 and footnote 3 to paragraph 6 of ED-ISA 570.
13. The IAASB deliberated these matters and reaffirmed its view that it would not be appropriate to define the term "material uncertainty." The term relates to an accounting concept and, as such, any definition developed by the IAASB may conflict with the definition provided in the applicable financial reporting framework, which would be undesirable. Further, as noted in footnote 3 to paragraph 6 of ED-ISA 570, different terminology may be used by financial reporting frameworks for this concept. In addition, the IAASB noted that a single definition for purposes of the ISAs may create unnecessary confusion, as the term is used in different contexts in other ISAs (e.g., ISA 705 (Revised and Redrafted)³). However, because the application of ISA 570 (Redrafted) requires a description of the meaning of a material uncertainty (particularly in the absence of a definition within the applicable financial reporting framework), the IAASB believes that this is best placed as part of the requirement in paragraph 17 of ISA 570 (Redrafted) to which it relates, as proposed in ED-ISA 570.
14. Regarding footnote 3 to paragraph 6 of ED-ISA 570 which refers to the meaning of the term as used in a particular financial reporting framework (IFRS) as an example, the IAASB concluded that that material serves as useful guidance to the related requirement in paragraph 17 of ISA 570 (Redrafted) and, accordingly, it has been repositioned as Application and Other Explanatory Material. See paragraph A19 of ISA 570 (Redrafted).

³ ISA 705 (Revised and Redrafted), "Modifications to the Opinion in the Independent Auditor's Report."

Appropriateness of Use of Going Concern Assumption

15. A few respondents noted that ED-ISA 570 does not provide requirements or guidance with respect to the auditor's conclusion as to whether the use of the going concern assumption is appropriate. This appeared inconsistent with the description of the auditor's responsibility in paragraph 6 and the objective in paragraph 9(a) of ED-ISA 570 which refer to the auditor's evaluation of, or obtaining of sufficient appropriate audit evidence in relation to, the appropriateness of management's use of the going concern assumption.
16. The IAASB noted that paragraphs 18-20 of ED-ISA 570 deal with the situation where the use of the going concern assumption is appropriate but a material uncertainty exists, and that paragraph 21 deals with the situation where the going concern assumption is inappropriate. The IAASB, nevertheless, agreed that the intended scope of paragraph 21 could be improved by aligning its wording with that of the objective of paragraph 9(a) of ISA 570 (Redrafted) and by clarifying that the requirement deals with the situation where the financial statements have been prepared on a going concern basis but, in the auditor's judgment, management's use of the going concern assumption in the financial statements is inappropriate. See paragraph 21 of ISA 570 (Redrafted).

Management Assessment of Entity's Ability to Continue as a Going Concern

17. A respondent noted that ED-ISA 570 omits a requirement for the auditor to request that management provide an assessment of an entity's ability to continue as a going concern when management has not prepared such an assessment, even though paragraph 22 of ED-ISA 570 addresses the actions required of the auditor when management is unwilling to make or extend its assessment when requested to do so by the auditor. It was also suggested that more should be said about what the auditor needs to do when management has not made a going concern assessment in order to communicate with those charged with governance, as well as provide an appropriate and informative auditor's report.
18. The IAASB does not believe it would be appropriate to include an unconditional requirement for the auditor to request management to make an assessment of the entity's ability to continue as a going concern. As stated in paragraph 22 of ED-ISA 570, the lack of analysis by management may not preclude the auditor from being satisfied about the entity's ability to continue as a going concern. The IAASB agreed, however, that the auditor should be required to make such a request when events or conditions have been identified that may cast doubt upon management's use of the going concern assumption in the preparation and presentation of the financial statements and management has not yet performed an assessment. Consequently, the IAASB elevated paragraph A6 of ED-ISA 570 to a requirement in paragraph 16(a) of ISA 570 (Redrafted).
19. The IAASB also considered whether the refusal by management to make or extend its assessment of the entity's ability to continue as a going concern when requested by the auditor to do so would be a significant matter of interest to those charged with governance, regardless of whether the financial reporting framework requires such an assessment. The IAASB concluded that it may be a significant matter, but not necessarily in all circumstances. When it is a significant matter, it would be required to be communicated

⁴ Therefore, the IAASB agreed that it is unnecessary to establish a new requirement, and that it would be inappropriate to do so in the absence of guidance on the matter in extant ISA 570. Doing otherwise would go beyond the scope of the redraft.

20. In considering the above, the IAASB observed some ambiguity about the relationship of the requirements addressing management's assessment of the entity's ability to continue as a going concern. In particular, the relationship between the risk assessment procedures, the evaluation of management's assessment, and the additional audit procedures when events or conditions are identified that may cast doubt on the entity's ability to continue as a going concern, and whether management had to have carried out its assessment when the auditor performed the risk assessment procedures. The IAASB agreed that the ISA should refer to management's *preliminary assessment* in relation to the auditor's risk assessment procedures, as this is how this assessment is referred to in the extant ISA. This would also draw a better distinction between the requirements and make clear the fact that management may not have completed its assessment at the time the auditor performs the risks assessment procedures. See paragraph 10 of ISA 570 (Redrafted).

Period of Management's Assessment subject to the Auditor's Evaluation

21. Paragraph 13 of ED-ISA 570 addressed the period of management's assessment subject to evaluation by the auditor. Some respondents requested that the IAASB adopt more precise language in the requirement and related application material to make clear, for example, that the intent is to specify a minimum period to be assessed by management and not restrict management from assessing a longer period, as may be required by law or regulation.
22. The IAASB accepted these proposals as they are consistent with extant ISA 570. See paragraph 13 of ISA 570 (Redrafted).
23. A few respondents questioned the basis of the principles in extant ISA 570 in regard to this requirement. The IAASB concluded that these were matters beyond the scope of the project to redraft extant ISA 570.

Feasibility of Management's Plans for Future Actions, and Written Representations

24. A respondent recommended that the requirement in paragraph 16(d) of ED-ISA 570 for the auditor to request specific written representations from management regarding its plans for future action should be extended to include representation about the feasibility of its plans.
25. The IAASB accepted this recommendation. It concluded that if management is not prepared to confirm its belief that its plans for future action are feasible, any audit evidence obtained in that respect would need to be called into question.

⁴ ISA 260 (Revised and Redrafted), "Communication with Those Charged with Governance."

26. In considering this matter, the IAASB revisited paragraph 16(b) of ED-ISA 570 and whether it is appropriate to require the auditor to obtain sufficient appropriate audit evidence about whether management's plans for future actions are feasible. The IAASB concluded that it is not practical as part of the redrafting exercise to elaborate on what the necessary procedures might be or what may constitute sufficient appropriate audit evidence in this regard. Accordingly, the IAASB redrafted the requirement to include the auditor's consideration of the feasibility of management's plans as part of the auditor's evaluation of management's plans in general. See paragraph 16(b) of ISA 570 (Redrafted).
27. A few respondents also suggested that the requirements in ED-ISA 570 should be expanded to include general written representation from relevant parties that they believe that their use of the going concern assumption is appropriate in the circumstances, and on the completeness of management's assessment.
28. The IAASB did not believe it necessary to expand the requirements of the ISA as suggested. The going concern assumption is implicit in the preparation and presentation of the financial statements in accordance with an applicable financial reporting framework. In addition, ISA 580 (Revised and Redrafted)⁵ requires that the auditor request management to represent that they have prepared financial statements that present fairly or give a true and fair view, and therefore already covers this point.

Considerations Specific to Smaller Entities and Evidence of Support or Guarantees for the Entity

29. Paragraph A15 of ED-ISA 570 contained guidance on considerations specific to smaller entities where an entity is largely financed by a loan from the owner-manager, or where an entity is dependent on additional support from the owner-manager. A respondent recommended that the guidance should be strengthened, for example, to require the auditor to obtain a specific written representation from the owner-manager confirming his or her intention and understanding that the loan to the entity is subordinate to loans made to the entity by banks or other creditors. Another respondent was of the view that guidance should be developed addressing the auditor's consideration of circumstances in which the an entity's ability to continue as a going concern is dependent upon the ongoing support from a third party such as a group or related company.
30. The IAASB agreed that the clarity of the guidance would be improved if it explained that the auditor may need to consider requesting written confirmation from those third parties of such continued support, and obtain evidence of their ability to provide such support. The IAASB concluded, however, that it would not be appropriate to require the auditor to obtain, in all cases, evidence of continued support and the ability to provide this support from a third party. Rather, the IAASB believes that auditors will need to apply judgment in assessing the risk pursuant to ISA 315 (Redrafted)⁶ and designing further audit procedures

⁵ ISA 580 (Revised and Redrafted), "Written Representations."

⁶ ISA 315 (Redrafted), "Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment."

pursuant to ISA 330 (Redrafted)⁷ to address those risks, which may or may not include the need to obtain written confirmations from these third parties or also written representations from management or those charged with governance, if applicable.

31. The IAASB also concluded that the substance of the guidance in paragraph A15 in ED-ISA 570 is applicable to entities of all sizes, not only smaller entities, where third-party loans or other support is important to the entity's ability to continue as a going concern. Accordingly, the IAASB added guidance to this effect in paragraph A18 of ISA 570 (Redrafted).

Considerations Specific to Public Sector Entities

32. Several respondents questioned the accuracy and adequacy of the guidance in paragraph A3 of ED-ISA 570 addressing considerations specific to public sector entities. Among other matters, one respondent maintained that going concern issues have no relevance to the audit of public sector entities, and another that these issues are not relevant to central governments, while others suggested that the guidance be expanded to deal with situations where government funding may be withdrawn from public sector entities. One respondent took the view that the going concern assumption always relates to particular functions, services or activities.
33. Based upon the views expressed by several of the respondents and the treatment of the going concern assumption for financial statements in the public sector as described in paragraphs 38 to 41 in the International Public Sector Accounting Standard (IPSAS) 1,⁸ the IAASB concluded that management's use of the going concern assumption is relevant to public sector entities generally, including central governments, and that the assumption relates to the financial statements for a particular financial reporting entity, not to particular functions, services or activities. Accordingly, on this basis and as suggested by some respondents, the IAASB agreed to include an introductory statement that the going concern assumption is also relevant to public sector entities generally. Additional guidance was provided that going concern risks may arise in, but are not limited to, situations where public sector entities operate on a for-profit basis, where government support may be reduced or withdrawn, or where there is privatization. The IAASB also agreed to clarify that events or conditions that may cast significant doubt on an entity's ability to continue as a going concern in the public sector may include situations where the public sector entity lacks funding for its continued existence or when policy decisions are made that affect the services provided by the public sector entity. See paragraph A1 of ISA 570 (Redrafted).

Essential Explanatory Material

34. ED-ISA 570 included text within the Requirements section that, in the IAASB's view, served to clarify the responsibilities of the auditor with respect to a particular requirement, thereby allowing the requirement to be understood on a stand-alone basis. Respondents expressed differing views on the treatment of such text: a few suggested that such text should be presented in the Application and Other Explanatory Material section of the ISA;

⁷ ISA 330 (Redrafted), "The Auditor's Responses to Assessed Risks."

⁸ IPSAS 1, "Presentation of Financial Statements."

others supported the treatment and recommended that similar treatment be provided for other similar text.

35. The IAASB has agreed in principle to limit the extent of essential explanatory material in the Requirements sections of ISAs in light of comments on the exposure drafts of other clarified ISAs that doing so may introduce ambiguity in relation to the responsibilities of the auditor. However, the IAASB also concluded that treatment of such material should be determined on a case-by-case basis. In regard to ED-ISA 570, the IAASB concluded, with the exception of material on material uncertainty (see discussion in paragraphs 12-14 of this document), that moving the last two sentences of paragraph 22 of ED-ISA 570 to the Application and Other Explanatory Material section of ISA 570 (Redrafted) would not affect the meaning of the relevant requirement. In alignment with these considerations, the IAASB decided that the other similar explanatory material ought to remain in the Application and Other Explanatory Material section of ISA 570 (Redrafted).

Documentation

36. Extant ISA 570 and ED-ISA 570 do not contain requirements or application material on audit documentation. Some respondents were of the view that because going concern is often a fundamental issue considered by the auditor during the audit, it would be appropriate for the IAASB to include a documentation requirement, or to provide guidance on the form and content of documentation, particularly in relation to circumstances where there is no going concern issue.
37. The IAASB concluded that it would not be appropriate to establish new requirements or guidance on audit documentation in ISA 570 (Redrafted). The scope of the project to clarify ISA 570 is limited to redrafting to reflect only the application of IAASB's Clarity conventions and matters of clarity generally. Accordingly, to establish new requirements or guidance not based on material in the extant ISA would go beyond that scope. Further, the IAASB believes that ISA 230 (Redrafted)⁹ establishes sufficient requirements and guidance to direct the auditor to the audit documentation required in the circumstances.

⁹ ISA 230 (Redrafted), "Audit Documentation."