

AUDIT CONSIDERATIONS IN RESPECT OF GOING CONCERN IN THE CURRENT ECONOMIC ENVIRONMENT

This Staff Alert references the pre-clarified ISAs. The clarified ISAs are effective for audits of financial statements for periods beginning on or after December 15, 2009. The clarified standards can be accessed at: www.ifac.org/auditing-assurance/clarity-center/clarified-standards

This alert is issued by staff of the International Auditing and Assurance Standards Board (IAASB) to raise auditors' awareness about matters relevant to the consideration of the use of the going concern assumption in the preparation of the financial statements in the current environment. In particular, management, those charged with governance and auditors alike will be faced with the challenge of evaluating the effect of the credit crisis and economic downturn on an entity's ability to continue as a going concern and whether these effects on the entity ought to be described, or otherwise reflected, in the financial statements.

While the Staff Audit Practice Alert, "Challenges in Auditing Fair Value Accounting Estimates in the Current Market Environment [October 2008]," refers to going concern in the context of the effects of valuation in illiquid markets, this alert addresses wider issues that are likely to be relevant to auditors of entities in all industries and of all sizes. While this alert refers principally to ISA 570, other ISAs contain requirements and guidance to assist the auditor in dealing with other issues that may also require particular attention in the current environment, such as inventory valuation and allowances for doubtful receivables.

This alert does not take account of matters specific to industries or jurisdictions, both of which will be relevant to the issues discussed below. Government responses to the crises have been substantial, but varied. Thus in some jurisdictions certain aspects of credit availability may have been resolved while others continue to cause difficulties; and the particular matters tackled by governments may differ as between jurisdictions. Similarly, governments have been considering assistance to certain industries, the nature of which may have a material effect on the matters discussed in this alert. Further, the effect of the credit crisis and economic downturn varies both as to its severity and timing depending on the industry and the jurisdiction.

Key Messages within This Alert

- The going concern assumption is a fundamental principle in the preparation of financial statements.
- The assessment of an entity's ability to continue as a going concern is the responsibility of the entity's management.
- The appropriateness of the use of the going concern assumption is a matter for the auditor to consider on *every* audit engagement.
- International Standard on Auditing (ISA) 570, "Going Concern," establishes the relevant requirements and guidance with regard to the auditor's consideration of the appropriateness of management's use of the going concern assumption and auditor reporting.
- The credit crisis and economic downturn have led to a lack of available credit to entities of all sizes, which may affect an entity's ability to continue as a going concern; this and other factors may be relevant in the auditor's evaluation of forecasts prepared by management to support its going concern assessment.
- The extent of disclosures in the financial statements is driven by management's assessment of an entity's ability to continue as a going concern, coupled with the disclosure requirements of the applicable financial reporting framework.
- Consideration of the need for an emphasis of matter paragraph in the auditor's report will be a difficult matter of judgment to be made in the context of the entity's circumstances; the mere existence of the credit crisis, though referred to in the financial statements, does not of itself create the need for an emphasis.

This alert does not amend or override the ISAs that are currently effective, the texts of which alone are authoritative. Reading the alert is not a substitute for reading the ISAs, relevant accounting standards or other authoritative material. The alert is not meant to be exhaustive and reference to the ISAs themselves should always be made. In conducting an audit in accordance with ISAs, auditors are required to comply with *all* the ISAs that are relevant to the engagement.¹

Background

The going concern assumption is a fundamental principle in the preparation of financial statements. Under the going concern assumption, an entity is ordinarily viewed as continuing in business for the foreseeable future with neither the intention nor the necessity of liquidation, ceasing trading or seeking protection from creditors pursuant to laws or regulations. Accordingly, unless the going concern assumption is inappropriate in the circumstances of the entity, assets and liabilities are recorded on the basis that the entity will be able to realize its assets, discharge its liabilities, and obtain refinancing (if necessary) in the normal course of business.

The assessment of an entity's ability to continue as a going concern is the responsibility of the entity's management; and the appropriateness of management's use of the going concern assumption is a matter for the auditor to consider on *every* audit engagement. 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, within International Financial Reporting Standards (IFRS), International Accounting Standard (IAS) 1, "Presentation of Financial Statements," requires management to make an assessment of an entity's ability to continue as a going concern:

"When preparing financial statements, management shall make an assessment of an entity's ability to continue as a going concern. Financial statements shall be prepared 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, those uncertainties shall be disclosed. When financial statements are not prepared on a going concern basis, that fact shall be disclosed, together with the basis on which the financial statements are prepared and the reasons why the entity is not regarded as a going concern.

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 balance sheet date. 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, a conclusion that the going concern basis of accounting is appropriate may be reached 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."²

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.

Other standards and guidance may also be relevant, such as those relating to disclosures of risks and uncertainties or to supplementary statements such as management discussion and analysis or similar.

Relevant Auditing Standards

International Standard on Auditing (ISA) 570,

¹ The complete set of ISAs that are currently effective are available for download at http://www.ifac.org/members/Downloads/2008_IAASB_Handbook_Part_I-Compliance.pdf.

² IAS 1 as at 1 January 2007, paragraphs 23-24.

“Going Concern,” establishes the relevant requirements and guidance and is discussed in more detail below. Management’s assessment of the entity’s ability to continue as a going concern is a key part of the auditor’s consideration of the going concern assumption.

The auditor’s responsibility is to consider, when planning and performing audit procedures and evaluating their results, the appropriateness of management’s use of the going concern assumption in the preparation of the financial statements.³ The auditor considers the appropriateness of management’s use of the going concern assumption even if the financial reporting framework used in the preparation of the financial statements does not include an explicit requirement for management to make a specific assessment of the entity’s ability to continue as a going concern.⁴

ISA 570 requires the auditor to consider going concern in the early stages of the audit (i.e., when planning the audit and performing risk assessment procedures) by considering whether there are events or conditions and related business risks which may cast doubt on the entity’s ability to continue as a going concern, and to remain alert during the audit for audit evidence to this effect.⁵

The auditor is required to evaluate management’s assessment of the entity’s ability to continue as a going concern.⁶ When events or conditions have been identified which may cast significant doubt on an entity’s ability to continue as a going concern, ISA 570 requires the auditor to consider whether they affect the auditor’s assessment of the risks of material misstatement and to:

- a. Review management’s plans for future actions based on its going concern assessment;
- b. Gather sufficient appropriate audit evidence to confirm or dispel whether or not a material uncertainty exists through carrying out audit procedures considered necessary, including

considering the effect of any plans of management and other mitigating factors; and

- c. Seek written representations from management regarding its plans for future action.⁷

The credit crisis and the economic downturn are likely to result in events or conditions being identified that will give rise to the auditor performing the audit procedures described in paragraph 26 of ISA 570.⁸

On the basis of the evidence obtained, ISA 570 requires the auditor to determine if, in the auditor’s judgment, a material uncertainty exists related to events or conditions that, alone or in aggregate, may cast significant doubt on the entity’s ability to continue as a going concern.⁹ A material uncertainty exists when the magnitude of its potential impact is such that, in the auditor’s judgment, clear disclosure of the nature and implications of the uncertainty is necessary for the presentation of the financial statements not to be misleading.¹⁰

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

It is important that auditors communicate with management and, where appropriate, those charged with governance early in the audit to obtain an understanding of how management intends to assess the entity’s ability to continue as a going concern and to enable the auditor to communicate any events or conditions relating to the going concern assumption that have already been identified during the audit. In some cases, management may have already made a preliminary assessment that the auditor would review when performing risk assessment procedures to determine whether events or conditions relating to the going concern assumption have been identified and whether management has plans to address them.

Management’s assessment of the going concern assumption involves making a judgment, at a particular point in time, about the future outcome of events or conditions which are inherently uncertain. Where management has made a preliminary

3 ISA 570, paragraph 2.

4 ISA 570, paragraph 9.

5 ISA 570, paragraphs 11-12.

6 ISA 570, paragraph 17.

7 ISA 570, paragraphs 12 and 26.

8 Paragraphs 27-29 of ISA 570 provide related guidance on the audit procedures that may be relevant.

9 ISA 570, paragraph 30.

10 ISA 570, paragraph 31.

assessment, it may be more likely in the current economic conditions that it will be necessary to update it at year-end given the speed with which conditions may be changing. The following factors are relevant:

- In general terms, the degree of uncertainty associated with the outcome of an event or condition increases significantly the further into the future a judgment is being made about the outcome of an event or condition. For that reason, most financial reporting frameworks that require an explicit management assessment specify the period for which management is required to take into account all available information.
- Any judgment about the future is based on information available at the time at which the judgment is made. Subsequent events can contradict a judgment which was reasonable at the time it was made.
- The size and complexity of the entity, the nature and condition of its business and the degree to which it is affected by external factors all affect the judgment regarding the outcome of events or conditions.

Material uncertainties related to events and conditions that may cast significant doubt on the entity's ability to continue as a going concern are recognized in the ISAs as audit matters of governance interest that the auditor should communicate to those charged with governance.¹¹ However, it is likely in the current climate that matters relevant to the assessment of the entity's ability to continue as a going concern are already being considered by those charged with governance, at least in the private sector. A failure to have considered relevant issues may represent a weakness in governance or risk management procedures, and may lead to inadequately prepared financial statements.

Degree of Consideration of the Going Concern Assumption

As noted above, IAS 1 indicates that the assessment of an entity's ability to continue as a going concern depends on the facts and circumstances. In times like the present, making this assessment may

become increasingly difficult, as the landscape in which entities are operating is rapidly changing, in particular as it relates to availability of credit and the impact on forecasts and budgets as the recession bites and the cost of borrowing rises.¹²

IAS 1 and ISA 570 acknowledge that entities with a history of profitable operations and ready access to financial resources *may not* need a detailed analysis to support the going concern assumptions. However, the effect of the credit crisis and economic downturn is likely to be that such an approach will no longer be appropriate for many entities. In particular, the implicit assumptions behind such an approach may no longer be valid in the current environment. Issues surrounding liquidity and credit risk may create new uncertainties, or may exacerbate those already existing. Even many well-respected entities with a long-standing history of profits and availability of credit may find it difficult to obtain or renew financing, either at all or on comparable terms. Further, entities that have typically relied on extensions of debt payments or waivers of debt covenants at year-end may find that these reliefs are no longer available from their lenders. In addition, the economic crisis may undermine the previous assumptions about profitability.

Consequently, entities that have not previously found the need to prepare a detailed analysis in support of the going concern assumption may need to give the matter further consideration. In many cases, the management of smaller entities may not have historically prepared a detailed assessment of the entity's ability to continue as a going concern, but instead may have relied on in-depth knowledge of the business and anticipated future prospects. Matters such as owner-manager support may become even more pertinent in the current economic environment.

Auditors will benefit from early discussion with entities about the nature of the assessment that may be appropriate in the circumstances of the entity, how the entity might best go about doing so, and what may be needed to supplement what has been done in prior years with more robust processes in light of the current market conditions.

¹¹ ISA 260, "Communication of Audit Matters with Those Charged with Governance," paragraph 11.

¹² Although central banks have been reducing interest rates in an attempt to stimulate economic activity in the current environment, banks may not necessarily be passing on such reductions to customers as they seek to improve margins and reflect revised risk assessments.

Period of Time Considered in Making a Going Concern Assessment

Ordinarily the applicable financial reporting framework, or sometimes relevant law or regulation, specifies the minimum time period that management is expected to consider when making its assessment. IAS 1, for example, requires that “management takes into account all available information about the future, which is at least, but is not limited to, twelve months from the balance sheet date.” Other frameworks look to twelve months from the approval of the financial statements, while still others limit the consideration to twelve months from the balance sheet date. ISA 570 requires the auditor to consider the same period as that used by management in making its assessment under the applicable financial reporting framework; however, if this assessment covers less than twelve months from the balance sheet date, the auditor is required to ask management to extend its assessment period to twelve months from the balance sheet date.¹³ If management is unwilling to make or extend its assessment when requested to do so by the auditor, the auditor is required to consider the need to modify the auditor’s report as a result of the limitation on the scope of the auditor’s work, as it may not be possible for the auditor to obtain sufficient appropriate audit evidence regarding the use of the going concern assumption in the preparation of the financial statements.¹⁴

The auditor also inquires of management as to its knowledge of events or conditions and related business risks beyond the period of assessment used by management that may cast significant doubt on the entity’s ability to continue as a going concern.¹⁵

Factors in the Current Environment that May Affect the Going Concern Assessment

Neither management nor the auditor can predict future events or conditions that may cause an entity to cease to continue as a going concern. The unexpected severity, speed and consequences of the credit crisis illustrate that fact only too well. It is for these reasons that ISA 570 states that the absence of any reference to going concern uncertainty in the financial statements or the auditor’s report cannot be

viewed as a guarantee that future events or conditions will not result in the entity ceasing to continue as a going concern.

Nevertheless, the current economic conditions do not change either management’s or the auditor’s responsibility relating to the going concern assumption. There is no doubt that the events of the past year and the outlook for the future present challenges that will need to be considered by management and auditors alike in meeting those responsibilities.

The ISA describes factors that may be relevant to management’s use of the going concern assumption and gives examples of events or conditions that may cast significant doubt on the going concern assumption including, but not limited to, a number of financial events that are becoming more prevalent in the current environment,¹⁶ such as:

- 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.
- Inability to comply with the terms of loan agreements.
- Loss of a major market, franchise, license or principal supplier.
- Non-compliance with capital or other statutory requirements.

The existence of one or more events or conditions highlighted in the ISA, as well as the examples mentioned in this alert, does not always signify that a material uncertainty exists. When identified, however, these events or conditions prompt the auditor to perform further audit procedures to gather sufficient appropriate audit evidence to confirm or dispel whether or not a material uncertainty exists. Such procedures include the consideration of the effect of any plans of management and other mitigating factors.

Availability of Credit

One major effect of the credit crisis and economic

¹³ ISA 570, paragraph 18.

¹⁴ ISA 570, paragraph 37.

¹⁵ ISA 570, paragraph 22.

¹⁶ ISA 570, paragraphs 7-8.

downturn is the lack of available credit to entities of all sizes. Turmoil in the banking sector has led to a general tightening of credit, which may have a pervasive effect on an entity's ability to continue as a going concern. In addition, as an entity's financial health changes, contractual terms in loans and other obligations, including debt covenants and guarantees, and an entity's compliance with such terms, are likely to be under greater scrutiny from lenders, and also from management and auditors.

There are a number of factors that may, in the circumstances of the entity, need to be considered, including:

- Whether banks may withdraw credit from entities that had previously had easy access to credit whenever necessary;
- Whether reductions in asset values or trading losses have led to breaches in lending covenants;
- Whether failure to comply with the respective covenants has resulted, or will result, in immediate demands from the lenders, or changes in the terms on which finance is available;
- Whether on-demand clauses in term loans affect the classification of such liabilities on an entity's balance sheet and whether the lenders may in fact invoke such clauses, rather than continuing a practice of granting waivers;
- Whether it is reasonable to assume that lenders will roll over existing credit facilities on similar terms, if at all;
- Whether banks are likely to be unwilling to commit to future renewal of credit facilities (e.g., to issue letters confirming that these facilities will be continued in the absence of unforeseen circumstances); and
- Whether guarantees or letters of support (e.g., from owners, those charged with governance or other group entities) will continue to be available, or of significant value.

While these factors do not in themselves necessarily create material uncertainties specific to an entity, they are likely to affect:

- The audit evidence that may be available (e.g., financial institutions may be reluctant to

provide confirmations regarding the likelihood of an extension or renewal of facilities from banks and third parties that they may have more readily provided in the past);

- The extent to which the implications of agreements need to be considered (e.g., in normal times an entity may clearly satisfy various covenants in an agreement, but in the current environment the margin, if any, may be less and therefore require more specific consideration); and
- The weight to be placed on such evidence as is available (e.g., finance may be promised from an individual but in the circumstances he or she may be unable to fulfill that commitment).

Management's assessment of whether, and to what extent, in light of such events or conditions, credit will be available in the future is likely to have an effect on the entity's forecasts, as discussed in the following section.

Forecasts and Budgets

An important component of the going concern assessment relates to an entity's ongoing forecasts and budgeting. In evaluating management's assessment, the auditor considers the process management followed to make its assessment, the assumptions on which the assessment is based and management's plans for future actions.¹⁷ In considering alternative strategies that management may have to overcome any adverse factors, considerations include their effectiveness and the ability of management to execute them.

Analysis of cash flow may be a significant factor in considering the future outcome of events or conditions in the evaluation of management's plans for future action. Assumptions that have been used in prior years may no longer be relevant and may need to be adjusted to account for the pressures of the current environment. Factors that may be relevant in evaluating forecasts prepared by management include:

- Whether senior management and those charged with governance have been appropriately involved and have given appropriate

¹⁷ ISA 570, paragraph 20.

attention to forecasts;

- Whether the assumptions used in the forecasts are consistent with assumptions that have been used in asset valuations and models for impairment;
- Whether the forecasts have been prepared on a monthly basis and, if so, how the forecasts reflect expected payment patterns (e.g., quarterly cash outflows such as tax installments, and variable cash inflows such as expected proceeds from the sale of assets);
- Whether the forecasts indicate months of insufficient cash and, if so, management's plans to deal with any shortfalls;
- Whether forecasts reflect an inappropriate management bias, in particular as broadly compared to others in a particular industry;
- How management's budget for the current period compares with results achieved to date;
- Whether the forecasts consider potential losses of revenue, including whether an inability of an entity to obtain letters of credit affects its international trade;
- Whether increases in the cost of borrowing have been factored into management's analysis, including potential increases in margin sought by banks and the effect of alternative sources of financing;
- Whether the forecasts account for trends typically noted in recessionary periods, such as reduced revenues, increased bad debts (because of trading conditions or the withdrawal of credit insurance), and extended credit terms to customers;
- Whether management has performed an appropriate sensitivity analysis, such as considering the effect of the loss of key customers or key suppliers due to bankruptcies;
- How the forecast deals with asset realizations, including whether these realizations are practicable and realistic in amount; and
- Whether the forecasts imply any future concerns over the entity's ability to meet debt covenant requirements.

Disclosures in the Financial Statements

Financial reporting frameworks specify the financial statement disclosures that are to be included in the financial statements. In addition to specific disclosures that may be required regarding a material uncertainty about the entity's ability to continue as a going concern, many financial reporting frameworks require disclosures of risks and uncertainties that assist users of the financial statements to better understand the entity's financial position, financial performance and cash flows.

For those entities that are significantly affected by the current economic conditions, management needs to consider how to address the risks arising from the current economic conditions in their financial statements under the applicable financial reporting framework.

Many financial reporting frameworks require that the financial statements provide sufficient disclosures to enable users to understand the effects of material transactions and events on the information conveyed in the financial statements (for example, IFRS). Many also require entities to disclose the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the reporting date, and how the entity manages those risks (for example, IFRS 7, "Financial Instruments: Disclosures."¹⁸). A combination of qualitative and quantitative disclosures, these disclosures provide an overview of the entity's use of financial instruments and the exposures to risks they create; disclosures of liquidity risk and credit risk will be helpful to investors as the economic landscape and future outlook unfolds.

Historically, when management has concluded that the entity is a going concern without related material uncertainty, this conclusion has not usually been expressly stated in the financial statements. However, even in such cases management may nevertheless consider it appropriate, or in fact may be required by the applicable financial reporting framework, to make disclosures in the current year's financial statements to set out the challenges management is facing in the current economic environment, how this affects the outlook for the entity and any uncertainties that could have an effect on the entity, whether material or not.

18 In referencing financial instruments, the standard incorporates simple financial instruments, such as accounts receivable and accounts payable, as well as more complex instruments, such as derivatives.

These could include, for example:

- Concerns over availability of credit, in particular if there are facilities due for renewal soon after the issuance of the financial statements;
- Developments in the industry and region in which the entity operates;
- Uncertainties regarding plans to sell assets or dispose of businesses; and
- Potential impairments of fixed assets and intangibles.

Further discussion within an entity's annual report (such as the Management's Discussion and Analysis section or equivalent) of management's assessment of the entity's funding position will be particularly relevant to users of the financial statements. Such discussion, when combined with required disclosures regarding debt maturities, help to provide a fuller view of an entity's outlook and future uncertainties. ISA 720¹⁹ deals with an auditor's responsibilities with regard to such other information, focusing primarily on the consistency between the audited and unaudited information and the steps necessary should any other information contain a material misstatement of fact.

Some regulators and standard setters have suggested that it may be useful for financial statement users trying to obtain an understanding of those matters if all the relevant disclosures required by the financial reporting framework were brought together in one place in the financial statements. If that is not practicable, an alternative would be to provide appropriate cross-references from the principal relevant note to the places where various other related disclosures are made.

The current economic conditions are likely to increase the level of uncertainty existing when management makes their judgment about the outcome of future events or conditions. However, while the effect of the current market conditions on individual entities requires careful evaluation, it should not necessarily be assumed that the general economic situation at the present time in itself means that a material uncertainty, which casts significant doubt on the ability of the entity to continue as a going concern, exists. Nor are extensive disclosures

necessarily indicative of the existence of a significant doubt on the entity's ability to continue as a going concern. In fact, an objective of the disclosures may be to explain why the going concern issues that affect the entity do not give rise to a significant doubt.

Specific Disclosures about Material Uncertainties

Disclosure in the financial statements is expected when material uncertainty exists related to events or conditions that, alone or in aggregate, may cast significant doubt on the entity's ability to continue as a going concern.

In evaluating the adequacy of such disclosures, ISA 570 indicates that the auditor considers whether the financial statements:

- a. Adequately describe the principal events or conditions that give rise to the significant doubt on the entity's ability to continue in operation and management's plans to deal with these events or conditions; and
- b. State clearly that there is a material uncertainty related to events or conditions which 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.²⁰

Forming the Opinion on the Financial Statements and the Implications for the Auditor's Report

Based on the audit evidence obtained, the auditor concludes whether management's use of the going concern assumption in the preparation of the financial statements is appropriate and determines what type of *opinion* is to be issued in the circumstances. If the auditor concurs with management's assessment, an unqualified opinion would be issued.²¹

Forming an opinion on the financial statements includes consideration of disclosures, certain of which assume more significance in times of uncertainty. A question for auditors to consider is whether the disclosures provided are coherent: for example, all relevant information may be included in the financial statements (or accompanying reports) but it may be

¹⁹ ISA 720, "Other Information in Documents Containing Audited Financial Statements."

²⁰ ISA 570, paragraph 32.

²¹ ISA 700, "The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements," establishes standards and provides guidance on the form and the content to be included in an auditor's report when an unqualified opinion is expressed.

insufficiently drawn together to enable the user of the financial statements to obtain an understanding of the position.

As in every audit, circumstances may arise that require the auditor to modify the opinion in the auditor's report (i.e., by issuing a qualified, adverse or a disclaimer of opinion).²² These are:

- The auditor is unable to obtain sufficient appropriate audit evidence about whether the going concern assumption is appropriate;
- The auditor disagrees with the information included in the financial statements in relation to going concern, because it is insufficient or incorrect; and
- The auditor disagrees with the basis on which the financial statements have been prepared – that is, management has used the going concern basis when the auditor considers that a liquidation basis is appropriate, or the auditor considers a going concern basis to be appropriate but management has used a liquidation basis.

Because of the significance of any auditor's modified opinion over the going concern basis of accounting, a published disagreement on this matter is rare though not impossible. For example, in some cases where a resolution to the entity's difficulties (such as an agreement on new facilities) is expected within a very short period, it may be possible to delay the finalization of the financial statements until the matter has been resolved and the uncertainty removed.

The Inclusion of Emphasis of Matter Paragraphs

Based on the audit evidence obtained, the auditor should determine if, in the auditor's judgment, a material uncertainty exists related to events or conditions that, alone or in the aggregate, that may cast significant doubt on the entity's ability to continue as a going concern.²³

If, in the auditor's judgment, notwithstanding management's conclusion that the use of the going

concern assumption is appropriate, there is a material uncertainty related to events or circumstances that, alone or in aggregate, may cast significant doubt on the entity's ability to continue as a going concern, ISA 570 requires the auditor to consider the adequacy of disclosure in the financial statements and to modify the auditor's *report* by including an appropriate emphasis of matter paragraph if the disclosure in the financial statements is adequate.²⁴

Management may consider it appropriate to make disclosures in order to reassure users of the financial statements about the entity's financial position in the light of the general uncertainty. Such disclosures may, therefore, reflect only the existence of general, or systemic, risk. Such disclosures may be considered important and appropriate in the circumstances to ensure that the financial position of the entity is placed in appropriate context given the general economic conditions and how those conditions may affect the entity. However, the fact that management has included such disclosures in the financial statements does not necessarily mean that there is a material uncertainty that warrants an emphasis of matter paragraph in the financial statements.

If, on the other hand, the uncertainty arises not only as a result of the systemic position but also because of circumstances specific to the entity, it is more likely that the auditor will judge it to be material.

The decision as to whether a disclosed uncertainty is a "material uncertainty" of the kind envisaged by this requirement (and by IAS 1²⁵) is a difficult one. As indicated above, a material uncertainty exists when the magnitude of its potential impact is such that, in the auditor's judgment, clear disclosure of the nature and implications of the uncertainty is necessary for the presentation of the financial statements not to be misleading.²⁶

As part of the IAASB's Clarity project, ISA 570 was redrafted but not revised. As part of the redrafting, the IAASB sought to clarify the meaning of paragraph 31 of the extant ISA that describes when a material uncertainty exists. In ISA 570 (Redrafted), this has

22 ISA 570, paragraphs 34-38, and ISA 701, "Modifications to the Independent Auditor's Report," establish standards and provide guidance on the form and the content of the modifications to the auditor's opinion in these circumstances.

23 ISA 570, paragraph 30.

24 ISA 570, paragraphs 32-33.

25 IAS 1, paragraph 23.

26 ISA 570, paragraph 31.

been clarified as follows (see paragraph 17):

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.

The changes recognize that, in fact, materiality of an uncertainty does not depend on size alone without regard to likelihood; and that, in the specific case of financial statements prepared under a fair presentation framework, misleading presentation derives either from failure to comply with the requirements of the applicable financial reporting framework or from failure to give fair presentation (or give a true

and fair view).

For completeness, it should be noted that paragraph 33 of ISA 570 also acknowledges that there may be extreme cases, such as situations involving multiple material uncertainties that are significant to the financial statements, when the auditor may consider it appropriate to express a disclaimer of opinion instead of adding an emphasis of matter paragraph. Such a disclaimer would only be considered when, notwithstanding having obtained sufficient appropriate audit evidence regarding each of the individual uncertainties, the auditor concludes that it is not possible to form an opinion on the financial statements due to the potential interaction of the uncertainties and their possible cumulative effect on the financial statements.

ISA 570 provides further guidance and examples of wording to be used the auditor’s report, depending on the circumstances. These may be summarized as follows:

Outcome	Consequence for management disclosure	Consequence for auditor’s opinion and report
Management concludes that the going concern basis is appropriate. No material uncertainties leading to a significant doubt about going concern have been identified.	Financial statements may nevertheless include disclosure explaining the conclusion on going concern and how this was reached.	Unmodified opinion – provided the auditor concurs with management’s assessment and supporting disclosures. An emphasis of matter paragraph referencing the disclosures is not required.
Going concern assumption appropriate but a material uncertainty exists.	Disclosures explaining the specific nature of the material uncertainties and why the going concern basis has still been adopted.	Unmodified opinion with emphasis of matter paragraph is included, highlighting the existence of material uncertainties – provided the auditor concurs with management’s assessment and supporting disclosures. This results in a modified report.
Management concludes that the going concern basis is not appropriate.	Disclosures explaining the basis of the conclusion and the accounting policies applied in drawing up financial statements on a non-going concern basis.	Unmodified opinion – provided the financial statements contain the necessary disclosures and the auditor considers the basis to be appropriate to the facts and circumstances. The auditor may consider it appropriate to include an emphasis of matter in these circumstances to draw the user’s attention to the basis of accounting used in the financial statements, resulting in a modified report.

Other ISAs

While this alert refers principally to ISA 570, other ISAs contain requirements and guidance that may assume more importance in the current environment. For example:

- ISA 240 (“The Auditor’s Responsibility to Consider Fraud in an Audit of Financial Statements”), in particular fraud risk factors arising from economic pressures;
- ISA 315 (“Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement”), in particular the auditor’s understanding of the economic environment and its effect on customers, suppliers and the availability of finance;
- ISA 540 (“Audit of Accounting Estimates”), in particular, the auditor’s evaluation of the reasonableness of management’s assumptions on which an estimate is based, since there is a risk that over-conservative (i.e., “big bath”) provisions may have been recorded to manage future earnings;
- ISA 560 (“Subsequent Events”), since events in the financial sector may have immediate and unexpected effects; and
- ISA 580 (“Management Representations”), in respect of matters arising from the economic climate (such as availability of finance and adequacy of provisioning against assets).

About the IAASB

The IAASB (www.iaasb.org) develops auditing and assurance standards and guidance for use by all professional accountants under a shared standard-setting process involving the Public Interest Oversight Board, which oversees the activities of the IAASB, and the IAASB Consultative Advisory Group, which provides public interest input into the development of the standards and guidance. The structures and processes that support the operations of the IAASB are facilitated by IFAC.

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