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STAFF PAPER

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IFRS Interpretations Committee Meeting

Project	Disclosure requirements about an assessment of going concern
Paper topic	Proposed amendments to IAS 1

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Purpose of this paper

1. In June 2012, the IFRS Interpretations Committee (the Interpretations Committee) received a request for clarification about IAS 1 *Presentation of Financial Statements*. This Standard includes guidance on when financial statements should be prepared on a going concern basis. It also requires that when management are aware of material uncertainties about the entity's ability to continue as a going concern, those uncertainties shall be disclosed. The submitter, the International Audit and Assurance Standards Board (IAASB), thinks that the guidance about the disclosure of these uncertainties is not clear.

2. At the November 2012 meeting of the Interpretations Committee you asked us to prepare a narrow-focus amendment to IAS 1 that answers two questions:

   (a) When should an entity be required to disclose information about material uncertainties related to events or circumstance that cast significant doubts upon the entity's ability to continue as a going concern?

(b) What is the objective of those disclosures about material uncertainties about the entity's ability to continue as a going concern and what disclosures should be required?

3. The purpose of this paper is:

(a) to present the proposed amendments to IAS 1 to you for discussion and review; and

(b) to ask you whether you also want us to align IAS 1 with international auditing requirements with respect to the time frame for the going concern assessment.

Paper structure

4. The paper is organised as follows:

(a) background;

(b) scope of proposed amendments;

(c) basis of the proposed amendments;

(d) staff recommendation about the proposed amendment to IAS 1;

(e) alignment of the IAS 1 assessment time frame with that of international auditing standards;

(f) Appendix A—proposed amendment to IAS 1, and

(g) Appendix B—proposed amendment to IAS 1 in mark-up.

Background

5. Going concern is addressed in paragraph 25 of 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.

6. It is also addressed in the *Conceptual Framework*:

> 4.1 The financial statements are normally prepared on the assumption that an entity is a going concern and will continue in operation for the foreseeable future. Hence, it is assumed that the entity has neither the intention nor the need to liquidate or curtail materially the scale of its operations; if such an intention or need exists, the financial statements may have to be prepared on a different basis and, if so, the basis used is disclosed.

7. We conducted outreach on this topic in August and September 2012. At issue are the narrow criteria for assessing going concern in paragraph 25 of IAS 1. The threshold for not preparing the financial statements on a going concern basis is a high one—the intention to cease trading or liquidate, or that there is no reasonable way to avoid such a fate. That assessment about the basis of preparation of the financial statements is made at the date of preparation. All respondents thought that the criteria in IAS 1 for assessing going concern as a suitable basis for the preparation of the financial statements are clear and that the rebuttal of the going concern presumption was set at a suitably high level—ie, intends to cease trading or liquidate or has no realistic alternative but to do so.

8. Many continue reading paragraph 25 as though the same high threshold also applies to the disclosure of material uncertainties in the going concern assessment.

If that is how the paragraph is interpreted, this interpretation leads to the conclusion that disclosure of material uncertainties will only occur when the going concern assumption is no longer appropriate and the entity is about to cease operations or go into liquidation. This is obviously too late to provide useful information—and would make the disclosure requirement meaningless. Many respondents expressed concern that these disclosures are rarely made in practice or are reported too late to provide useful information to investors.

Scope of proposed amendments

9. At the November 2012 meeting you asked us to address the issue of when material uncertainties should be disclosed and what should be disclosed about those uncertainties. An extract of the November 2012 *IFRIC Update* is included below for reference:

> IAS 1 *Presentation of Financial Statements*—Disclosures about going concern
>
> The Interpretations Committee received a request for clarification on IAS 1 *Presentation of Financial Statements*. This Standard requires that when management are aware of material uncertainties about the entity's ability to continue as a going concern, those uncertainties shall be disclosed. The Interpretations Committee tentatively decided to deal only with two questions about this disclosure—when to disclose and what to disclose about these uncertainties.
>
> The Interpretations Committee tentatively decided that these two questions should be addressed as a narrow-focus amendment to IAS 1.
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> The Interpretations Committee tentatively agreed that:
>
> - the high threshold for preparing financial statements on a basis other than going concern is appropriate;

- a threshold for the disclosure of material uncertainties should be identified more clearly in the Standard;
- the Standard should include objectives for this disclosure; and
- the staff should prepare a proposal about what specific disclosures, if any, should be required.

10. In drafting the proposed amendments to IAS 1, we have kept to this brief. See paragraph 17 for the basis of the proposed amendments.

Related literature

11. For completeness in preparing the proposed amendments, and in addition to reviewing our own outreach, we have also reviewed the following related documents and projects:

    (a) guidance produced by the submitter, the IAASB;

    (b) the work of the Sharman Inquiry; and

    (c) the current going concern project of the FASB.

Guidance produced by the IAASB

12. Auditing guidance about the going concern assumption has developed in recent years. The International Standard of Auditing 570 *Going Concern* was effective from 15 Dec 2009. In addition, in June 2012 the submitter, the IAASB, initiated public consultation on improving the audit report *Invitation to Comment: Improving the Auditor's Report*.

13. The comments received on this public consultation were discussed at the December meeting of the IAASB, where it was decided to continue to explore what statements should be made about going concern in audit reports. The

IAASB also decided to continue to monitor developments about going concern here and at the FASB.

Sharman Inquiry

14. In 2011 the UK Financial Reporting Council (FRC) commissioned the Sharman Inquiry *Going Concern and Liquidity Risks: Lessons for Companies and Auditors* (Preliminary report issued November 2011; Final report issued June 2012). The report includes a detailed discussion about the issues involved in assessing and reporting on going concern and recommends that the current corporate governance, financial reporting and auditing going concern requirements should be moulded into a more integrated framework. It also recommends that the IASB and the IAASB should work closely together to achieve this.

FASB project on going concern

15. At their November 2012 meeting the FASB agreed to pursue a project that requires management to formally perform going concern assessments and to provide related footnote disclosures. This represents a significant change in practice in the US where the onus to perform a going concern assessment currently rests with auditors.

Basis of the proposed amendments

16. The proposed narrow-focus amendment to IAS 1 is attached for your review:

    (a) Appendix A contains a 'clean' form of the revised paragraph 25 of IAS 1 as it would appear in the revised Standard. In our view, it is easier to understand the proposed guidance in this form without the distraction of the drafting mark-up.

    (b) Appendix B contains the proposed amendments in mark-up in order to highlight the changes made.

17. The following comments summarise the basis used for preparing the proposed narrow-scope amendment to IAS 1.

    (a) In drafting the proposed amendments we have tried to change the existing guidance as little as possible. In the absence of a Basis for Conclusions for IAS 1, we are wary of altering the IASB's wording for fear of unintended consequences. In particular, the section relating to going concern as a basis of preparation for the financial statements, which works well in practice, remains substantially unchanged.

    (b) We have inserted "for the foreseeable future" into the guidance because it is the time frame used in the *Conceptual Framework* in relation to going concern. We think that this clarifies the time frame required by the IASB in making this assessment and it also harmonises the wording of IAS 1 with that of the *Conceptual Framework*. Before amendment, paragraph 26 refers simply to 'the future'. 'Foreseeable future' is also compatible with the wording used in international auditing standards.

    (c) The Standard, as originally issued, contained two separate notions—going concern as a basis for the preparation of financial statements and a requirement to disclose material uncertainties about an entity's ability to continue as a going concern. Outreach conducted suggested that part of the reported diversity in practice arose because the distinction between these two, separate requirements was not sufficiently clear in the Standard. For clarity we have restructured the going concern section into three separate topics—basis of preparation; identification of material uncertainties and disclosure.

    (d) The proposed amendment consists mainly of entirely new requirements (25D-25H) that provide guidance on how to identify material uncertainties and what to disclose in relation to material uncertainties.

    (e) We received conflicting advice on how detailed this guidance should be. Some think that quoting factors that may indicate whether uncertainties are material or examples of possible indicators of financial distress is useful; others argue that such examples blur the principles involved and can lead to divergence in practice. We have included factors indicating material uncertainty and indicators of financial distress (at paragraphs 25E and 25F respectively) for discussion.

18. IAS 1 does not include a Basis for Conclusions. In amending the Standard, we will include a self-contained Basis for Conclusions with the heading 'Identification and disclosure of material uncertainties- 2013'. This Basis of Conclusions, based on your discussions at the January 2013 meeting and the guidelines contained in paragraph 17, will be circulated before the proposed amendments are sent to the IASB.

Question 1

(a) Do you have any comments or suggestions about the proposed amendments in Appendices A and B?

(b) Do you agree with the level of detail provided in the guidance in relation to paragraphs 25E and 25F?

Staff recommendation about the proposed amendment to IAS 1

19. The staff ask the Interpretations Committee to recommend the proposed amendment to the IASB for deliberation.

Question 2

Do you agree with the staff recommendation to recommend the proposed amendment to IAS 1, revised for any comments received at the January meeting, to the IASB for deliberation?

Alignment of the IAS 1 assessment time frame with that of international auditing standards

20. In developing the proposed amendment to IAS 1, some members of the Interpretations Committee recommended that we should extend the proposed amendment in order to align the quoted assessment time frame in IAS 1 with that of International Standard on Auditing 570 *Going Concern* (ISA 570).

21. The time frame in IAS 1 is worded as:

> 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. …

22. The time frame required by ISA 570 is at least 12 months from the date of the financial statements as defined in ISA 560 *Subsequent Events*. This is the date of finalisation of the financial statements.

23. This difference in time frame can be a source of contention between auditors and their clients. Some think that we should take this opportunity to align IAS 1 with ISA 570 by changing the assessment time frame in IAS 1 to a date that is 12 months from the date that the financial statements are finalised.

24. Supporters of this view refer to IAS 10 *Events after the Balance Sheet Date* which states, in paragraph 14, that:

> An entity shall not prepare its financial statements on a going concern basis if management determnines *after the reporting period* either that it intends to liquidate the entity or cease trading or has no realistic alternative but to do so. *[Emphasis added]*

25. In their view, this shows that the going concern assessment is a continuous one and one that happens up to the date on which the financial statements are finalised. They are concerned that the current time frame in IAS 1 does not adequately cover those entities that may take several months to prepare and finalise their financial statements. They also note that the submitter (the IAASB) and the Sharman Inquiry have both suggested that the IASB should align IFRSs with auditing and regulatory requirements where possible.

Staff recommendation

26. The staff do not recommend amending IAS 1 to align the going concern assessment time frame with that of ISA 570.

(a) The proposed amendment was requested to deal with diversity in practice in relation to the timely disclosure of material uncertainties. In particular, there was concern at a perceived failure to forewarn investors of the high-profile collapse of some entities as a result of the financial crisis. We are not aware that the distinction between preparation and finalisation time-scales was a factor in these collapses. In our view, adding this topic to the scope of the amendments will delay addressing these concerns about disclosure.

(b) The time frame stated in paragraph 26 of IAS 1 is fundamental to the Standard and the discrepancy in time frames may not be easy to resolve. In our view, the Standard defines the time frame in terms of the end of the reporting period in order to give certainty to the assessment time period. When making the initial assessment about whether the financial statements should be prepared on a going concern basis, the only known date at that time is the end of the reporting period. Although many listed entities publish their reporting timetable, we do not think it would be appropriate to revise the wording to a form such as '12 months from the date at which the finacial statements will be finalised', because this date cannot be identified at the time of initial assessment for most entities.

(c) Some point to IAS 10 as evidence that the going concern assessment is continuous. It is true that the going concern assessment made at preparation needs to be updated throughout the finalisation process, but we think that these are two different assessments, covered by two different Standards. IAS 1 deals with the preparation and presentation of the financial statements; IAS 10 deals with a reassessment of any judgements made or assumptions used in preparing the financial statements that may be affected by subsequent events or changes in facts and circumstance. Pargraphs 14-16 of IAS 10 specifically require that the going concern assumption is reassessed after the reporting period.

(d) We are also concerned that if the time frame is articulated as 12 months from the date of finalisation, management of distressed entities may interpret that as an opportunity to postpone making the going concern assessment from the date of preparation of the financial statements (as at the end of the reporting period) to the date of finalisation of the financial statements. For distressed entities, finalisation of the financial statements may be considerably delayed after their preparation. As a result of postponing the going concern assessment until finalisation, some entities might be, knowingly or unknowingly, trading while insolvent. In our view the current articulation, 12 months from the end of the reporting period, reinforces the requirement to make that assesment on intial preparation rather than at finalisation.

27. IFRS are based, at present, on the entity continuing as a going concern for the foreseeable future. IAS 1 currently acknowledges that the assessment is at least, but not limited to, 12 months from the end of the reporting period. ISA 570 refers to 12 months from the date of finalisation of the financial statements. In our view, if we were to amend the time frame in any way, it would be better to strengthen a clear principle in some way, perhaps using ‘foreseeable future’ as a proxy, rather than substituting one framework’s bright-line time frame for another’s.

Question 3

Do you agree with the staff recommendation not to extend the scope of this narrow-focus amendment to include a harmonisation of time frames between IAS 1 and ISA 570?

Appendix A

Proposed amendment to IAS1 *Financial Statement Presentation*

Revised paragraphs 25-26, after amendment

Going concern

Basis of preparation of financial statements

25 When preparing financial statements, management shall make an assessment of an entity's ability to continue as a going concern for the foreseeable future. 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.

25 A In assessing whether the going concern assumption is appropriate, management takes into account all available information about the foreseeable 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.

25 B 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.

Identification of material uncertainties

25 C when management is aware, in making its going concern assessment, of material uncertainties about the entity's ability to continue as a going concern for the foreseeable future, the entity shall disclose those uncertainties.

25 D Even when management determines that the going concern assumption is a suitable basis for the preparation of the financial statements, information about these material uncertainties will still provide useful information to users of the financial statements. The disclosure of material uncertainties should be a warning signal that one or more risks have been heightened to the point where knowledge of that fact would be material to users in making decisions.

25 E Management will need to apply judgement in identifying whether these uncertainties are material. . In making that judgement, management should consider the following factors:

(a) the nature of the uncertainty;

(b) the magnitude of the potential impact on the entity if the event or condition giving rise to the uncertainty occurs;

(c) the likelihood of that event or condition occurring; and

(d) the likely timing of the event or condition giving rise to the uncertainty.

25 F Material uncertainties may be indicated when management can foresee possible future indicators of financial distress or operating constraints, such as:

(a) the breach, or foreseeable breach, of borrowing or other contractual covenants;

(b) the inability to make new investments essential to sustain the business;

(c) reliance on obtaining or retaining one specific contract or customer; or

(d) the discontinuance or curtailment of some operations.

Such uncertainties are also signified when the entity foresees levels of financial distress that mean that management may have no realistic alternative but to take remedial action outside its intended normal course of business. This situation may be indicated by events or conditions such as:

(a) the need to raise or renegotiate finance; and

(b) the disposal of the entity's assets earlier than planned at the time of acquisition of the asset or other than through its normal trading activities.

Disclosure

25 G An entity shall disclose information that enables users of the financial statements to understand the judgements made and assumptions used in assessing whether going concern is an appropriate basis for the preparation of the financial statements. When material uncertainties are identified with respect to an entity's ability to continue as a going concern, the entity shall disclose information that enables users of financial statements to:

(a) identify those uncertainties regarded as material;

(b) assess the feasibility of the remedial actions or mitigating factors available to the entity; and

(c) understand the effect of any significant future transactions that may be taken by management to ensure that the entity continues as a going concern.

25 H To comply with paragraph 25 G, the disclosures should:

(a) describe the critical judgements made and assumptions used in relation to management's assessment of the entity's ability to continue as a going concern;

(b) describe the principal events or conditions that give rise to any material uncertainties with respect to the entity's ability to continue as a going concern;

(c) provide information about remedial or mitigating actions available to the entity, their effectiveness and the extent to which management can control those actions ;

(d) include details of any other facts and circumstances required to meet the objectives of paragraph 25G; and

(e) state clearly that these circumstances were identified as part of management's assessment of the entity's ability to continue as a going concern.

[26 Deleted]

Appendix B

Proposed amendment to IAS 1 *Financial Statement Presentation*

Paragraph 25 and 25A are amended and paragraph 26 is renumbered as 25B. Paragraphs 25C-H are inserted. New text is underlined.

Going concern

<u>Basis of preparation of financial statements</u>

25 When preparing financial statements, management shall make an assessment of an entity's ability to continue as a going concern <u>for the foreseeable future</u>. 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.

25 A (formerly 26) In assessing whether the going concern assumption is appropriate, management takes into account all available information about the <u>foreseeable</u> 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.

25 <u>B</u> (order changed) **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.

Identification of material uncertainties

25 C When management is aware, in making its going concern assessment, of material uncertainties ~~related to events or conditions that may cast significant doubt upon~~ about the entity's ability to continue as a going concern for the foreseeable future, the entity shall disclose those uncertainties.

25 D Even when management determines that the going concern assumption is a suitable basis for the preparation of the financial statements, information about these material uncertainties will still provide useful information to users of the financial statements. The disclosure of material uncertainties should be a warning signal that one or more risks have been heightened to the point where knowledge of that fact would be material to users in making decisions.

25 E Management will need to apply judgement in identifying whether these uncertainties are material. In making that judgement, management should consider the following factors:

(a) the nature of the uncertainty;

(b) the magnitude of the potential impact on the entity if the event or condition giving rise to the uncertainty occurs;

(c) the likelihood of that event or condition occurring; and

(d) the likely timing of the event or condition giving rise to the uncertainty.

25 F Material uncertainties may be indicated when management can foresee possible future indicators of financial distress or operating constraints, such as:

(a) the breach, or foreseeable breach, of borrowing or other contractual covenants;

(b) the inability to make new investments essential to sustain the business;

(c) reliance on obtaining or retaining one specific contract or customer;

(d) the discontinuance or curtailment of some operations.

Such uncertainties are also signified when the entity foresees levels of financial distress that mean that management may have no realistic alternative but to take remedial action outside its intended normal course of business. This situation may be indicated by events or conditions such as:

(a) the need to raise or renegotiate finance; and

(b) the disposal of the entity's assets earlier than planned at the time of acquisition of the asset or otherwise than through its normal trading activities.

Disclosure

25 G An entity shall disclose information that enables users of the financial statements to understand the judgements made and assumptions used in assessing whether going concern is an appropriate basis for the preparation of the financial statements. When material uncertainties are identified with respect to an entity's ability to continue as a going concern, the entity shall disclose information that enables users of financial statements to:

(a) identify those uncertainties regarded as material;

(b) **assess the feasibility of the remedial actions or mitigating factors available to the entity; and**

(c) **understand the effect of any significant future transactions that may be taken by management to ensure that the entity continues as a going concern.**

25 H To comply with paragraph 25 G, the disclosures should:

(a) describe the critical judgements made and assumptions used in relation to the management's assessment of the entity's ability to continue as a going concern;

(b) describe the principal events or conditions that give rise to any material uncertainties with respect to the entity's ability to continue as a going concern;

(c) provide information about remedial or mitigating actions available to the entity, their effectiveness and the extent to which management can control those actions ;

(d) include details of any other facts and circumstances required to meet the objectives of paragraph 25G; and

(e) state clearly that these circumstances were identified as part of management's assessment of the entity's ability to continue as a going concern.

[26 Deleted]