IFRS™

Agenda Paper 8 B

STAFF PAPER

November 2013

Project	**IAS 1 *Presentation of Financial Statements*—Disclosure requirements about an assessment of going concern**
Paper topic	Key conclusions and examples for discussion

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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 events or conditions that cast significant doubt upon 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 its November 2012 meeting, the Interpretations Committee tentatively decided 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 and what disclosures should be required?

3. The proposed narrow-focus amendment to IAS 1 was discussed at the January 2013 meeting of the Interpretations Committee, at which it recommended these

proposals to the IASB for deliberation. At the IASB's March 2013 meeting you discussed these proposals and asked us to further develop these proposals.

4. The purpose of this paper is to:

   (a) discuss with you the key conclusions that have been taken in developing the proposals to date;

   (b) test the validity of those conclusions by applying the proposals to some simple examples;

   (c) answer any questions, or receive any suggestions, that you have on this project; and

   (d) ask you whether you would like us to develop an Exposure Draft of the proposed amendments to IAS 1.

Paper structure

5. The paper is organised as follows:

   (a) summary of our conclusions about disclosures about going concern;

   (b) expected effect of these proposals;

   (c) proposed disclosure trigger;

   (d) examples for discussion; and

   (e) staff recommendation.

Summary of our conclusions about disclosures about going concern

6. The following assumptions were used as the basis from which to develop the proposed amendment to IAS 1.

Retain the existing definition of the going concern assumption

7. The outreach conducted by the Interpretations Committee in Q3 2012 confirmed that the existing description of 'going concern', and the resulting high threshold used when confirming going concern as the basis of preparation of the financial

statements, works well in practice and is considered appropriate by respondents. The requirement relating to going concern appears in paragraph 25 of IAS 1:

> 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.

8. **We do not intend to change the current requirements about going concern as a basis of preparation for the financial statements in any way.**

Address disclosures about going concern

9. The concern raised by most respondents in outreach, and separately by auditors and regulators, relates to the disclosures that are required about going concern. Management are required to make an assessment of the entity's ability to continue as a going concern and to disclose material uncertainties identified in making that assessment:

> … 25 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. ….

10. Many respondents think that these disclosures are either made too late to be useful or are boilerplate disclosures that do not provide users with relevant information. Some respondents also think that this deficiency in disclosure has become more apparent as a result of the financial crisis. A few respondents think that no disclosures about going concern would be required if management, as a result of their going concern assessment, conclude that going concern is the appropriate basis for preparing the financial statements,

11. **The objective of any amendment would be to ensure that disclosures about going concern are timely and relevant.**

Net assessment of going concern is unchanged

12. In making their assessment of the entity's ability to continue as a going concern, management will take into consideration what mitigating action could be taken by them to counteract the effect of each event or condition to ensure that they do not have to liquidate the entity or to cease trading. Management need to assess whether the mitigating actions identified are sufficient to counteract the events or conditions that gave rise to the significant doubt and whether that assessment allows them to conclude that the entity has a realistic alternative to being liquidated or to cease trading.

13. The assessment of going concern in IFRS is thus a net one that takes into account both components: the events or conditions that cast doubt and any mitigating actions. This assessment results in a simple yes or no conclusion in IFRS—going concern is either an appropriate basis for the preparation of the financial statements or it is not.

14. **We do not intend to alter the basis for assessing going concern in any way. Consequently, we do not think our proposals would change the current outcome of the going concern assessment.**

An explicit trigger for disclosure

Identify events or conditions that could affect going concern

15. We were concerned that the proposed disclosures should not include all and any potential risks to the entity, because this could result in disclosure overload. Important disclosures about going concern could be obscured by boilerplate comprehensive risk disclosures.

16. We decided to specify when disclosures should be made by providing guidance about how to identify events or conditions that cast significant doubts upon an entity's ability to continue as a going concern. We think that in making that assessment management should consider the following factors for each event or condition:

    (a) *magnitude of the impact on the entity*—is the outcome so severe that, if the event or condition happens, the entity would cease trading or go into liquidation?

(b) *likelihood of that outcome occurring*—how likely is it that the threat to going concern will occur?

(c) *timing of the event or condition taking place*—how soon could the threat to going concern occur? The longer the time before the entity is affected by the event or condition, the greater is management's ability to take mitigating action.

Trigger for disclosure is existence of events or conditions that give rise to significant doubt

17. Many respondents to outreach conducted by the Interpretations Committee think that it is not clear in IAS 1 when disclosures about going concern should be made. Respondents in a few jurisdictions think that no disclosures are required if management conclude that going concern is an appropriate basis for preparation of the financial statements, because planned mitigating actions are sufficient to remove the significant doubt about an entity's ability to continue as a going concern. In other jurisdictions disclosure may be driven by auditors who rely on the disclosure requirements in paragraph 17 of ISA 570 to trigger disclosure by their clients and this occurs at the net assessment phase. Many respondents concluded that disclosures about going concern are not made or are made too late to be useful to investors.

18. In order to provide useful information to investors, we think that the trigger for disclosure needs to be based on the existence of events or conditions that give rise to significant doubt about the entity's ability to continue as a going concern, and that the decision to disclose should be taken before considering any future, or incomplete, mitigating actions.

19. When management assess both the events or conditions that give rise to doubt and the planned mitigating actions, they apply judgement. In particular, management must assess the feasibility and effectiveness of any planned mitigating actions. If disclosure was triggered only after management had reached a conclusion on the net assessment, all the judgement and uncertainty involved in making that assessment would have already taken place and not be subject to scrutiny by investors. In our view, once management have identified that there are events or conditions that cast significant doubt upon the entity's ability to continue as a going concern, disclosures about material uncertainties should be required. We

think that this is the case even if management conclude that the proposed mitigating actions are adequate to avoid liquidation or cessation of trading.

20. By specifying that disclosure is required for any entity that has identified events or conditions that give rise to significant doubt about that entity's ability to continue as a going concern, diversity in disclosures will be lessened or removed and the disclosures about going concern will be made earlier, which is when they are most relevant to users.

21. **We propose that disclosure is triggered by the existence of events or conditions that,**

    (a) by the magnitude of their impact on the entity, and

    (b) by their likelihood; and

    (c) **by their timing**

    cast significant doubt upon the entity's ability to continue as a going concern.

Need for disclosure about both components of the going concern assessment

22. Management's assessment of the entity's ability to continue as a going concern is based on two components:

    (a) identification of events or conditions that cast significant doubt upon the entity's ability to continue as a going concern; and

    (b) identification and assessment of mitigating actions that could be taken to avoid liquidation or cessation of trading.

23. Consequently, investors need information about the events or conditions that cast significant doubt upon an entity's ability to continue as a going concern. They also need information about any mitigating action that management is in the process of taking or propose to take. There are uncertainties that relate to each of the two components of the assessment and so information about the uncertainties that relate to each component will need to be separately disclosed.

24. Disclosure of the uncertainties about the events or conditions and the mitigating action would then allow investors to review management's judgement and understand the basis of its (implicit) conclusion that the entity is a going concern.

25. Investors are interested in predicting future results and cash flows. Consequently, they are interested in information about any proposed mitigating actions, because these are likely to include significant future transactions, such as rights issues or asset sales, that cannot be anticipated from the underlying operating trends of the business.

26. **In accordance with this view, disclosures about both components of the going concern assessment would be required once the events or conditions that cast significant doubt upon the entity's ability to continue as a going concern have been identified.**

Alter the existing wording as little as possible

27. We think that it is right to propose changing the existing guidance as little as possible. In the absence of a Basis for Conclusions for IAS 1, we are wary of altering the wording in IAS 1 more than in order to avoid unintended consequences.

28. **We propose that the Standard is amended only to specify that the trigger for disclosure is the existence of events or conditions that affect going concern and that disclosures, when made, should include information about both components of the going concern assessment.**

Summary and question for the IASB

29. These conclusions about disclosure about going concern can be summarised as:

    (a) We do not intend to change the current requirements about going concern as a basis of preparation for the financial statements in any way.

    (b) The objective of any amendment would be to ensure that disclosures about going concern are timely and relevant.

    (c) We do not intend to alter the basis for assessing going concern in any way. Consequently, we do not think that our proposals would change the current outcome of the going concern assessment.

    (d) We propose that disclosure is triggered by the existence of events or circumstances that, by their magnitude, likelihood and timing, cast significant doubt upon the entity's ability to continue as a going concern.

(e) Disclosures about both components of the going concern assessment would be required once the events or conditions that cast significant doubt have been identified.

(f) We propose that the Standard is amended only to specify that the trigger for disclosure is the existence of events or conditions that by their magnitude, likelihood and timing cast significant doubt upon the entity's ability to continue as a going concern and that disclosures, when made, should include information about both components of the going concern assessment.

Question 1
Do you agree with the key conclusions in paragraphs 6-29?

Expected effect of these proposals

30. We can illustrate the effect of these proposals by considering the four possible sets of circumstances faced by management:

Circumstances	**Basis of preparation**	**Disclosure requirements**
No alternative but to cease trading or liquidate	Going concern is not appropriate	Disclose that going concern is not the basis of preparation. Explain what basis is used, as required currently by paragraph 25 of IAS 1.
There are realistic alternatives to ceasing trading or liquidation and no intention to do so. No events or conditions that cast doubt on ability to continue as a going concern are identified.	Going concern is appropriate	None
There are realistic alternatives to ceasing trading or liquidation and no intention to do so. Events or conditions that cast doubt on ability to continue as a going concern are identified, but no material uncertainties remain after taking mitigating actions into account.		Disclose information about the events or conditions that cast doubt and describe mitigating actions and their feasibility and effectiveness.
There are realistic alternatives to ceasing trading or liquidation and no intention to do so. Events or conditions that cast significant doubt on ability to continue as a going concern are identified and there are remaining material uncertainties about their effect on the entity after taking mitigating actions into account.		

31. In our view:

(a) going concern as a basis for the preparation of the financial statements will be unaffected by these proposals;

(b) the going concern assessment as applied to an individual entity will remain unchanged;

(c) there are diverse views about the effect that the proposed disclosure trigger will have on current practice; and

(d) when going concern disclosures are made, those disclosures, in general, include information about both components of the going concern assessment, ie about the events or conditions and the mitigating actions.

32. In general, the application of the existing going concern presumption will remain unchanged in financial statements. The exception to this is the proposal for an explicit disclosure trigger. The proposals about the disclosure trigger are discussed below.

Proposed disclosure trigger

33. We propose that the trigger for disclosures about going concern should be the existence of events or conditions that by their magnitude, likelihood and timing give rise to significant doubt about an entity's ability to continue as a going concern. This trigger would apply even if management think that planned mitigating actions are adequate to remove this doubt.

34. The requirement that management should make disclosures about going concern is contained in paragraph 25 of IAS 1:

> IAS 1.25 …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. ..

35. The Interpretations Committee carried out consultations by outreach in August 2012 about the trigger for making going concern disclosures and found that there was significant diversity about when disclosure of material uncertainties should be made. Paragraph 25 of the Standard is interpreted in three different ways:

(a) *No trigger for disclosure* A few respondents to outreach think that, if management concludes that going concern is an appropriate basis for the preparation of the financial statements, any material uncertainties about going concern must have been resolved and disclosures are not required.

(b) *A net trigger for disclosure* Some read paragraph 25 to mean that these disclosures are only required if, after taking account of mitigating actions, management think there is still a material uncertainty that may cast significant doubt upon an entity's ability to continue as a going concern. In practice, disclosures are often made in this case at the prompting of the entity's auditors, who would be required to deliver an adverse or qualified opinion when they think that material uncertainties remain and that those uncertainties are not adequately disclosed.

(c) *A gross trigger for disclosure* Others read paragraph 25 of the Standard to mean that if there are any uncertainties about the events or conditions that could cast significant doubt upon the entity's ability to continue as a going concern, disclosures must be made about the uncertainties identified in making the going concern assessment. Supporters of this view think that in making an assessment about the entity's ability to continue as a going concern, management exercise judgement about material uncertainties with respect to both the events or conditions that cast significant doubts about an entity's ability to continue as a going concern and about the feasibility and effectiveness of any planned or proposed mitigating activities. These respondents think that disclosure of the judgements involved in making these assessments is useful information for investors.

36. We support this last view and think that IAS 1 should require that disclosure is triggered by the *existence* of the events or conditions that cast significant doubt upon an entity's ability to continue as a going concern. We propose that IAS 1 should be amended to include additional guidance to clarify how to identify these events or conditions and to specify that the existence of such events or conditions, before consideration of possible mitigating actions, is the trigger for disclosure.

37. In the proposed amendment, the identification of events or conditions that cast significant doubt on an entity's ability to continue as a going concern would be based on an assessment against three factors:

(a) *magnitude of the outcome of those events or conditions on the entity*—is the outcome so severe that, if the event or condition happens, the entity would have no realistic alternative but to cease trading or go into liquidation? In assessing the magnitude of the outcome, management should take into account existing mitigating events or conditions, but not future or incomplete mitigating actions.

(b) *likelihood of that outcome occurring*—how likely is the threat to going concern to occur? Note that it is the likelihood of the (negative) *outcome* that casts doubt on going concern that is being assessed, not the likelihood of the initial event occurring.

(c) *timing of the event or condition taking place*—how soon could the threat to going concern occur? The longer the time before the entity is affected by the event or condition, the greater is management's ability to take mitigating action.

38. If, after considering all three factors, management conclude that the event or condition identified casts significant doubt upon the entity's ability to continue as a going concern, disclosures about management's going concern assessment would be required.

Examples for discussion

39. We would like to test these proposed factors (magnitude, likelihood and timing) against some common examples to see whether you think:

(a) that the trigger for disclosure is appropriate; and

(b) that the proposed wording is sufficiently clear to consistently identify that trigger.

40. Of course, the judgement required to make this assessment in practice will also depend on further facts and circumstances, specific to the entity, that are not given in these examples. Nonetheless, in which of the following examples should management identify events or conditions that may cast significant doubt upon an entity's ability to continue as a going concern and, consequently, be required to make disclosures about going concern?

Change in trading circumstances

41. A defence contractor operates principally in Europe. It has a number of long-term contracts (5-15 years) with several European governments. Should either of the following scenarios be identified as events or conditions that may cast significant doubt on the entity's ability to continue as a going concern? In each example, the likelihood is high and the time scale is short because the event has already happened. The factor that we need to assess for each is the *magnitude* of the outcome that the event will have on the entity.

    (a) As a result of the financial crisis, its largest customer announces that its contracts with the defence contractor will be held at the minimum drawdown level for the next 5 years. In the current year, the customer's elective drawdown contributed an operating profit of CU20m[1], or 20 per cent of the entity's operating profit.

    Although we think that this is useful information for inclusion in the management commentary, we do not think that this event is of sufficient magnitude to affect going concern.

    (b) As a result of the financial crisis, four European governments announce a moratorium on defence spending for three years. Consequently, these governments will delay their purchases from the contractor by three years. This will mean that 35 per cent of the contractor's trading activities will be suspended for three years. If trading activities are reduced by 35 per cent, the entity will be unable to cover its fixed costs and will not be able to generate sufficient cash to continue trading.

    This reduction in activity is likely to be of such magnitude that it would affect its going concern assessment. In that case, this event should be disclosed. (Let us assume that the entity will not be required to cease trading because this business is lost and that the financial statements are prepared on a going concern basis.)

[1] In this Staff Paper, currency amounts are denominated in 'currency units' (CU).

Financing examples

42. An entity has relied for many years on bank financing; that level of finance is required to continue trading. Its current borrowing facilities expire on 21 June. The entity has had the facility with its bank for 10 years and the facility has always been rolled over each year with no change in the terms. The entity has been able to service its debt from operations throughout the last 10 years.

43. If the facility is not renewed or replaced, this is of such magnitude and timing that non-renewal of the borrowing facilities would cast significant doubt on the entity's ability to continue as a going concern. Should either of the following scenarios be identified as events or conditions that may cast significant doubt on the entity's ability to continue as a going concern? The entity must assess the *likelihood* of the financial support being withdrawn by the bank.

    (a) At the reporting date, the entity conforms in all respects with the bank's existing terms and conditions, and management think that the entity will continue to meet these terms for the foreseeable future; ie the entity's total borrowings are not expected to exceed CU1 million and the entity's gearing ratio (defined by the bank) will not exceed 1.8.

    We think that it is unlikely that that the bank will withdraw its support in June and consequently this would not need to be disclosed as an event that affects going concern. (The term of the borrowings at the reporting date would need to be disclosed as part of the borrowings' disclosure.)

    (b) At the reporting date, the entity had broken one of its covenants under the terms of its agreement with the bank—its gearing ratio was 2.6—but management think that this could be reduced to 1.8 by 21 June by selling a surplus property.

    The entity is currently in breach of the bank's conditions, so the likelihood of the bank withdrawing support has increased. We think that this triggers going concern disclosures, ie the entity should disclose that its bank facility is due for renewal in June, as part of its going concern assessment.

Examples in relation to significant external events

Availability of raw materials

44. An engineering firm is very dependent on the ready availability of metal X. The engineering firm would have to stop manufacturing its current product unless metal X were available, so a lack of availability of metal X is of sufficient magnitude to require the entity to cease trading. Consider the effect of the *timing* of the event in two scenarios:

    (a) Experts think that global supplies of X will become scarce by 2030.

    We did not think that this was likely to be a factor in X's going concern assessment, although it is useful information for discussion in the management commentary and for an understanding of its business strategy. In this example, the entity would be likely to have sufficient time to reengineer its processes or alter its specifications to overcome this problem in the time available.

    (b) An unexpected collapse in supply was announced to take place within one or two years, after which metal X would no longer be available. *We think that this would constitute a risk to going concern, because the entity would be likely to have insufficient time in which to redesign its product. If management conclude that going concern is the appropriate basis for the preparation of the financial statements, the collapse of supplies of metal X should be disclosed as an event that gives rise to significant doubt about the entity's ability to continue as a going concern.*

Change in regulation

45. A financial services entity is heavily regulated and must comply with all regulations or else cease trading. Current regulation requires a defined leverage ratio of at least 5 per cent to be maintained at all times. The entity's leverage ratio is currently 5.5 per cent and management forecast that this ratio will be maintained at at least this level for the foreseeable future.

46. If the leverage ratio requirement is not satisfied, then the banking supervisor could require the bank to cease trading, ie the magnitude of the event is sufficient

to affect going concern. The entity must assess the *likelihood* of this happening in each scenario and the effect of *timing* on that assessment:

(a) The regulator announces that the 5 per cent ratio will apply for the next five years.

The entity exceeds the requirement and management expect this to continue for the foreseeable future. Consequently, we do not think that this would need to be disclosed as an event or condition that casts significant doubt upon the entity's ability to continue as a going concern.

(b) At the entity's year-end, the regulator announces that the required leverage will be increased to 6.0 per cent in six months' time. Management is confident that future profits will ensure that the required ratio will be achieved in six months' time.

Although management think that they will achieve the new ratio in time, at present they are short of that target. In addition, 6 months is not a long period of time in which to increase the ratio. Consequently, we think that this change in regulation is likely to cast significant doubts upon the entity's ability to continue as a going concern and this should be disclosed.

(c) The regulator announces that the ratio will be set at 10 per cent in two years' time. Management think that future profits and the sale of surplus assets will enable them to meet this ratio in two years' time.

We do not have information about the surplus assets or how likely it is that they would realise enough to achieve the target, although we accept that two years will give management some time to sell assets and improve the ratio. Even so, we think that this change in regulation represents an event that is likely to cast doubt upon the entity's ability to continue as a going concern and should be disclosed as such. Management will be able to disclose the mitigating actions that they intend to take to achieve the new requirements and, for example, quantify the effect of any asset sales in that disclosure.

Question 2

(a) Do you agree with the outcomes discussed in these examples?

(b) Do you think the proposals would result in consistent identification at the intended trigger point if the facts and circumstances specific to an entity were identical?

Staff recommendation

47. The staff recommend that the conclusions about going concern, summarised in paragraphs 6-29, should be used as the basis on which to prepare a narrow-scope amendment to IAS 1 that will clarify when disclosures are made about management's assessment of going concern and what those disclosures should be.

Question 3

Do you agree with the staff recommendation that the summary conclusions about management's assessment of going concern in this paper should be used as the basis for a narrow-scope amendment to IAS1?