AUSTRALIAN AUDITING STANDARDS

FACT SHEET FOR MANAGEMENT, DIRECTORS AND AUDIT COMMITTEE MEMBERS

ASA 570 Going Concern

OBJECTIVE

The objective of this Fact Sheet is to explain the auditor's role in relation to the auditor's responsibility in the audit of a financial report with respect to the going concern assumption used in the preparation of the financial report, including considering management's assessment of the entity's ability to continue as a going concern.

APPLICATION

Financial reporting periods commencing on or after 1 July 2006.

Definitions

"Going concern basis" means the accounting basis whereby in the preparation of the financial report the reporting entity is viewed as a going concern, that is, the entity is expected to:

- be able to pay its debts as and when they fall due; and
- continue in operation without any intention or necessity to liquidate or otherwise wind up its operations.

"Relevant period" means the period of approximately 12 months from the date of the auditor's current report to the expected date of the auditor's report for:

- the next annual reporting period in the case of an annual financial report; or
- the corresponding reporting period for the following year in the case of an interim reporting period.

Management's Responsibility

The going concern assumption is a fundamental principle in the preparation of the financial report. 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, assets and liabilities are recorded on the basis that the entity will be able to realise its assets and discharge its liabilities in the normal course of business.

Accounting Standard AASB 101 *Presentation of Financial Statements* requires management to make an assessment of an enterprise's ability to continue as a going concern. In addition, the *Corporations Act 2001*, requires a formal statement as to the solvency of the entity to be made by members of the governing body and included as part of the financial report upon which the auditor's opinion is expressed. Since the going concern assumption is a fundamental principle in the preparation of the financial report, management has a responsibility to assess the entity's ability to continue as a going concern even if the financial reporting framework does not include an explicit responsibility to do so. When there is a history of profitable operations and a ready access to financial resources, management may make its assessment without detailed analysis.

Management's assessment of the going concern assumption involves making a judgement, at a particular point in time, about the future outcome of events or conditions which are inherently uncertain. The following factors are relevant:

- 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 judgement about the future is based on information available at the time at which the judgement is made. Subsequent events can contradict a judgement 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 judgement regarding the outcome of events or conditions.

Examples of events or conditions, which may give rise to business risks, that individually or collectively may cast significant doubt about the going concern assumption are set out below.

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Financial

- Net liability or net current liability position.
- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.
- Indications of withdrawal of financial support by debtors and other creditors.
- Negative operating cash flows indicated by historical or prospective financial reports.
- Adverse key financial ratios.
- Substantial operating losses or significant deterioration in the value of assets used to generate cash flows.
- Arrears or discontinuance of dividends.
- Inability to pay creditors on due dates.
- Inability to comply with the terms of loan agreements.
- Change from credit to cash-on-delivery transactions with suppliers.
- Inability to obtain financing for essential new product development or other essential investments.

Operating

- Loss of key management without replacement.
- Loss of a major market, franchise, license, or principal supplier.
- Labour difficulties or shortages of important supplies.
- Lack of strategic direction including appropriately documented policies, plans and forecasts such as forward budgets and cash flow projections.
- Deficiencies in the governing body, for example lack of independent members, low level of involvement in key decisions, poor documentation and communication of decisions, imbalance or lack of expertise amongst members.
- Concentration of risk in a limited number of products or projects.
- Prolonged industrial relations difficulties.
- Deficiencies in management information systems, including blockages in information flows, or lack of management action in response to information received.
- Rapid or unplanned development of business (particularly in non-core activities) without commensurate developments in information systems, management expertise, financing structures, pricing policies, etc.
- Uninsured or underinsured disasters such as drought, flood, fire, fraud or sabotage.

Other

- Non-compliance with capital or other statutory requirements.
- Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that are unlikely to be satisfied.
- Changes in legislation or government policy expected to adversely affect the entity.
- Undue influence of a market dominant competitor.
- Technical developments which render a key product obsolete.
- Failure of other entities in the same industry.
- Lack of adequate back-up and recovery capabilities for key financial or other information systems.

The significance of those indications which are related to cash flow or solvency can often be mitigated by the existence of, and management plans with respect to, factors such as those listed below:

Asset factors

- disposability of assets that are not operationally interdependent;
- capability of delaying the replacement of assets consumed in operations or of leasing rather than purchasing certain assets; and
- possibility of using assets for factoring, sale and leaseback, or similar arrangements.

Debt factors

- availability of unused lines of credit or similar borrowing capacity;
- capability of renewing or extending the due dates of existing loans; and
- possibility of entering into debt restructuring agreements, eg rescheduling of loan repayments.

Cost factors

- separability of operations producing negative cash flows;
- capability of postponing expenditures for such matters as maintenance or research and development; and
- possibility of reducing overhead and administrative expenditures.

Equity factors

- variability of dividend requirements;
- capability of obtaining additional contributions by owners; and
- possibility of increasing cash distributions from subsidiaries or associates.

Loss of a principal supplier

- availability of a suitable alternative source of supply.

The auditor's responsibility

When planning and performing audit procedures and in evaluating the results thereof, the auditor is required under ASA 570 to consider:

- the appropriateness of management's use of the going concern assumption in the preparation of the financial report.
- whether there are material uncertainties about the entity's ability to continue as a going concern that need to be disclosed in the financial report; and
- the appropriateness of management's use of the going concern assumption even if the financial reporting framework used in the preparation of the financial report does not include an explicit requirement for management to make a specific assessment of the entity's ability to continue as a going concern.

The auditor cannot predict future events or conditions that may cause an entity to cease to continue as a going concern. Accordingly, the absence of any reference to going concern uncertainty in an auditor's report cannot be viewed as a guarantee as to the entity's ability to continue as a going concern.

Planning the Audit and Performing Risk Assessment Procedures

In obtaining an understanding of the entity, the auditor is required under ASA 570 to consider whether there are events or conditions and related business risks which may cast significant doubt on the entity's ability to continue as a going concern.

The auditor is required under ASA 570 to remain alert for audit evidence of events or conditions and related business risks, which may cast significant doubt on the entity's ability to continue as a going concern, in performing audit procedures throughout the audit. This allows for more timely discussions with management, review of management's plans and resolution of any identified going concern issues. If such events or conditions are identified, the auditor is required to, in addition to performing procedures specified in ASA 570, consider whether they affect the auditor's assessment of the risks of material misstatement.

In some cases, management may have already made a preliminary assessment when the auditor is performing risk assessment procedures. If so, under ASA 315 *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, the auditor needs to review that assessment to determine whether management has identified events or conditions pertinent to the going concern assumption, and management's plans to address them.

If management has not yet made a preliminary assessment, the auditor ordinarily discusses with management the basis for their intended use of the going concern assumption, and enquires of management whether specific events or conditions exist. The auditor may request management to begin making its assessment, particularly when the auditor has already identified events or conditions relating to the going concern assumption.

Evaluating Management's Assessment

The auditor is required under ASA 570 to evaluate management's assessment of the entity's ability to continue as a going concern and the relevant period. If management's assessment of the entity's ability to continue as a going concern covers less than the relevant period used by the auditor, the auditor is required to ask management to extend its assessment period to correspond to the relevant period used by the auditor.

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. Most financial reporting frameworks requiring an explicit management assessment specify the period for which management is required to take into account all available information. In evaluating management's assessment, the auditor ordinarily considers:

- The process management followed to make its assessment, the assumptions on which the assessment is based and management's plans for future action.
- Whether the assessment has taken into account all relevant information of which the auditor is aware as a result of the audit procedures.

When events or conditions have been identified which may cast significant doubt about the entity's ability to continue as a going concern, the auditor needs to perform additional audit procedures.

Period Beyond Management's Assessment

The auditor is required under ASA 570 to enquire 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.

Ordinarily, the auditor is to be alert to the possibility that there may be known events, scheduled or otherwise, or conditions that will occur beyond the period of assessment used by management that may bring into question the appropriateness of management's use of the going concern assumption in preparing the financial report. The auditor may become aware of such known events or conditions during the planning and performance of the audit, including subsequent events procedures. The indications of going concern issues will need to be significant before the auditor ordinarily considers taking further action. The auditor may need to ask management to determine the potential significance of the event or condition on its going concern assessment.

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The auditor does not have a responsibility to design audit procedures other than enquiry of management to test for indications of events or conditions which cast significant doubt on the entity's ability to continue as a going concern beyond the period assessed by management which would be at least the relevant period.

Further Audit Procedures when Events or Conditions are Identified

When events or conditions have been identified which may cast significant doubt on the entity's ability to continue as a going concern, the auditor is required under ASA 570 to:

- review management's plans for future actions based on its going concern assessment;
- gather sufficient appropriate audit evidence to confirm or dispel whether or not a material uncertainty exists; and
- endeavour to obtain written representations from management regarding its plans for future action.

Events or conditions which may cast significant doubt on the entity's ability to continue as a going concern may be identified in performing risk assessment procedures or in the course of performing further audit procedures. The process of considering events or conditions continues as the audit progresses. When the auditor believes such events or conditions may cast significant doubt on the entity's ability to continue as a going concern, the auditor ordinarily:

- Enquires of management as to its plans for future action, including its plans to liquidate assets, borrow money or restructure debt, reduce or delay expenditures, or increase capital.
- Considers whether any additional facts or information is available since the date on which management made its assessment.
- Obtains sufficient appropriate audit evidence that management's plans are feasible and that the outcome of these plans will improve the situation.

Audit procedures that are relevant in this regard may include:

- Analysing and discussing cash flow, profit and other relevant forecasts with management.
- Analysing and discussing the entity's latest available interim financial report.
- Reviewing the terms of debentures and loan agreements and determining whether any have been breached.
- Reading minutes of the meetings of shareholders, those charged with governance and relevant committees for reference to financing difficulties.
- Enquiring of the entity's lawyer regarding the existence of litigation and claims and the reasonableness of management's assessments of their outcome and the estimate of their financial implications.
- Confirming the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties and assessing the financial ability of such parties to provide additional funds.
- Considering plans to deal with unfilled customer orders.
- Reviewing events after period end to identify those that either mitigate or otherwise affect the ability to continue as a going concern.

When analysis of cash flow is a significant factor in considering the future outcome of events or conditions, ordinarily the auditor considers:

- the reliability of the entity's information system for generating such information; and
- whether there is adequate support for the assumptions underlying the forecast.

In addition the auditor ordinarily compares the prospective financial information for:

- recent prior periods with historical results; and
- the current period with results achieved to date.

Audit Conclusions and Reporting

Appendix 1 to ASA 570 provides the following diagrammatic representation of the reporting options available to the auditor in respect of going concern issues.

Going Concern Basis Considered Appropriate

When there are no other matters requiring modification to the auditor's report and the auditor is satisfied that it is appropriate, based on all reasonably foreseeable circumstances facing the entity, for management to prepare the financial report on the going concern basis, the auditor is required under ASA 570 to issue an unmodified auditor's report in accordance with ASA 700 *The Auditor's Report on a General Purpose Financial Report*.

When consideration of mitigating factors, in particular management's plans, have had a significant effect upon the auditor in forming the opinion that the going concern basis is appropriate, the auditor is required under ASA 570 to specifically consider the adequacy of the disclosure of the following matters in the financial report:

- the principal conditions which caused the auditor to question the going concern basis, including as appropriate, management's evaluation of their significance and possible effects; and
- management's plans and other mitigating factors, including as appropriate, relevant prospective financial information.

If the disclosures considered necessary by the auditor are not made, the auditor is required under ASA 570 to express a qualified opinion on the basis of the lack of disclosure in accordance with ASA 701 Modifications to the Auditor's Report.

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Material Uncertainty

Based on the audit evidence obtained, the auditor is required under ASA 570 to determine if, in the auditor's judgement, 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.

Going Concern Assumption Appropriate but a Material Uncertainty Exists

When this uncertainty is adequately disclosed in the financial report, the auditor's report is required under ASA 570 to include an emphasis of matter section in accordance with ASA 701. An emphasis of matter section regarding a going concern uncertainty shall:

- state clearly that there is significant uncertainty whether the entity will continue as a going concern and, therefore, whether it will realise its assets and extinguish its liabilities in the normal course of business and at the amounts stated in the financial report; and
- adequately describe, or refer to a note to the financial report that adequately describes:
  - the principal conditions that raise doubt about the entity's ability to continue as a going concern; and
  - the extent to which the financial report includes appropriate adjustments, if any, relating to the recoverability and classification of recorded asset amounts or to the amounts and classification of liabilities that might be necessary if the entity does not continue as a going concern.

In evaluating the adequacy of the financial report disclosure, the auditor needs to consider whether the information explicitly draws the reader's attention to the possibility that the entity may be unable to continue realising its assets and discharging its liabilities in the normal course of business. An illustration of a modified auditor's report with such a paragraph when the auditor is satisfied as to the adequacy of the note disclosure is included as example 1 at Appendix 3 to ASA 570. In extreme cases, such as situations involving multiple material uncertainties that are significant to the financial report, the auditor may consider it appropriate to express a disclaimer of opinion instead of adding an emphasis of matter paragraph.

If adequate disclosure is not made in the financial report, the auditor is required under ASA 570 to express a qualified or adverse opinion, as appropriate. The report shall include specific reference to the fact that there is a material uncertainty that may cast significant doubt about the entity's ability to continue as a going concern.

Going Concern Assumption Inappropriate

If, in the auditor's judgement, the entity will not be able to continue as a going concern, the auditor is required under ASA 570 to express an adverse opinion if the financial report had been prepared on a going concern basis. This is so regardless of whether or not disclosure has been made that the going concern assumption used in the preparation of the financial report is inappropriate.

When the entity's management has concluded that the going concern assumption used in the preparation of the financial report is not appropriate, the financial report needs to be prepared on an alternative authoritative basis. If on the basis of the additional audit procedures carried out and the information obtained the auditor determines the alternative basis is appropriate, ordinarily the auditor can issue an unqualified opinion if there is adequate disclosure but may require an emphasis of matter in the auditor's report to draw the user's attention to that basis.

Management Unwilling to Make or Extend Its Assessment

If management is unwilling to make or extend its assessment when requested to do so by the auditor, the auditor is required under ASA 570 to consider the need to modify the auditor's report as a result of the limitation on the scope of the auditor's work. It is not the auditor's responsibility to rectify the lack of analysis by management, and a modified report may be appropriate because it may not be possible for the auditor to obtain sufficient appropriate evidence regarding the use of the going concern assumption in the preparation of the financial report.

In some circumstances, the lack of analysis by management may not preclude the auditor from being satisfied about the entity's ability to continue as a going concern. For example, the auditor's other procedures may be sufficient to assess the appropriateness of management's use of the going concern assumption in the preparation of the financial report because the entity has a history of profitable operations and a ready access to financial resources. In other circumstances, however, the auditor may not be able to confirm or dispel, in the absence of management's assessment, whether or not:

- events or conditions exist which indicate there may be a significant doubt on the entity's ability to continue as a going concern; or
- the existence of plans management has put in place to address them or other mitigating factors.

In these circumstances, under ASA 701, the auditor needs to modify the auditor's report.

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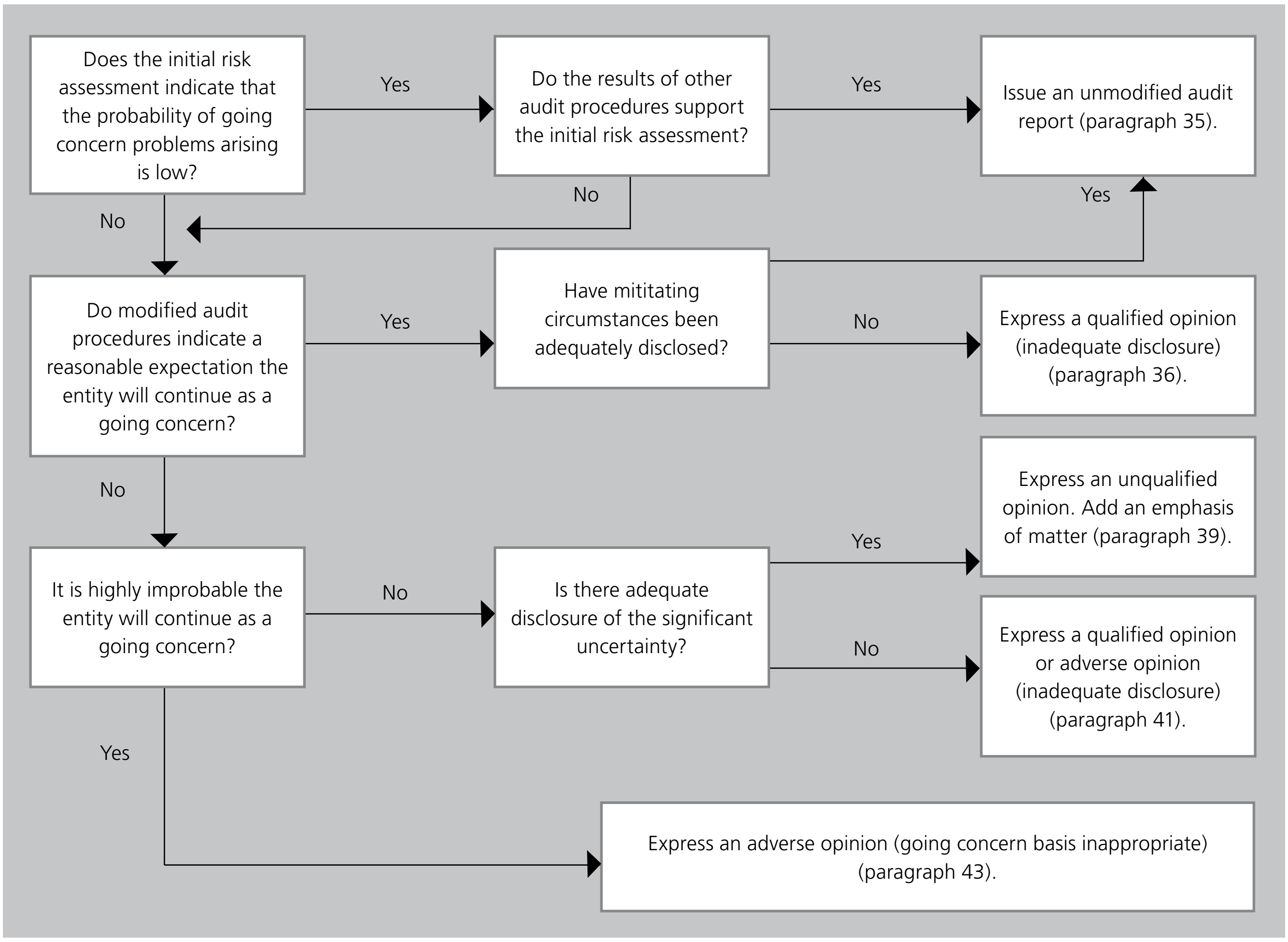
Linking Going Concern Considerations with Types of Audit Opinions



Significant Delay in the Signature or Approval of the Financial Report

When there is significant delay in the signature or approval of the financial report by those charged with governance and management after the balance sheet date, the auditor ordinarily considers the reasons for the delay. When the delay could be related to events or conditions relating to the going concern assessment, the auditor needs to consider the need to perform additional audit procedures, as well as the effect on the auditor's conclusion regarding the existence of a material uncertainty.

Communicating with Those Charged With Governance and Management

The auditor is required under ASA 570 to communicate with those charged with governance or management, as soon as practical, the impact on the auditor's report where:

- there is a material uncertainty;
- the going concern assumption is inappropriate; or
- management is unwilling to make or extend its assessment.

Other Considerations

An auditor is required by section 311 of the *Corporations Act 2001* to notify the Australian Securities and Investments Commission (ASIC) if the auditor is aware of certain circumstances. ASIC Practice Note 34 *Auditors' Obligations: Reporting to ASIC* provides guidance to help auditors comply with their obligations under section 311 of the Act, such as reporting suspected insolvent trading.

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This fact sheet series has been developed by CPA Australia. For further information visit **cpaaustralia.com.au**

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