

Emphasis of Matter and Material Uncertainties Related to Going Concern (Lecture A770–15.09 minutes)

While this section has recently been covered in previous updates, there still appears to be confusion surrounding the use of Emphasis of Matter (EoM) and Material Uncertainties Related to Going Concern (MURGC) paragraphs. This confusion results in auditors' reports which are not technically correct, fail to comply with the requirements of the ISAs (UK) and result in failures of audit files.

With the above in mind, we consider it worthwhile revisiting the technical areas where audit firms appear to be confused.

1.1 EoM paragraphs

As we discussed in the Quarter 3 update, an EoM paragraph is used to refer to a matter which has been adequately presented or disclosed in the financial statements by the directors. The auditor will include an EoM paragraph when they consider that the matter(s) is of such fundamental importance to users' understanding that attention should be drawn to the matter in the auditor's report.

What is going wrong?

File reviews have indicated that some auditor's reports contain inappropriate EoM paragraphs. In some, more serious cases, it is clear that the auditor has used an EoM paragraph as a substitute for modifying the auditor's opinion. For example, an incorrect accounting treatment or inadequate disclosure has been dealt with through an EoM paragraph rather than through a modified auditor's opinion.

If an EoM paragraph is used as a substitute for a modified opinion, the auditor may receive sanctions from their professional body. Audit risk is the risk that the auditor forms an incorrect opinion on the financial statements. Where an unmodified opinion is expressed when a modified opinion should have been expressed, but an EoM paragraph is used instead as a substitute for modifying the opinion, the auditor has still expressed the wrong opinion on the financial statements.

EoM paragraphs are **not** a substitute for a modified opinion and cannot be used as such. Keep in mind the definition of an EoM paragraph according to ISA (UK) 7606 *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report* which is:

A paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.

ISA (UK) 706,
para 7

The definition above confirms that such a paragraph is only to be used in respect of a matter which is appropriately presented or disclosed in the financial statements. It does not refer to it being a substitute for a modified audit opinion. Indeed, all EoM paragraphs must refer to the paragraph **not** modifying the auditor's opinion in respect of the matter(s) being emphasised.

Example – Incorrect use of an EoM paragraph

An auditor's report contains the following EoM paragraph:

Emphasis of matter

In our opinion, the information given in the strategic report and directors' report for the financial year for which the financial statements are prepared are consistent with the financial statements.

We have nothing to report in respect of the following matters where the Companies Act 2006 requires us to report to you if, in our opinion:

- adequate accounting records have not been kept, or returns adequate for our audit have not been received from branches not visited by us; or
- the financial statements are not in agreement with the accounting records and returns; or
- certain disclosures of directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit.

Heading up this section 'Emphasis of matter' is incorrect. The matters above are not matters which should be covered in an EoM paragraph; they are opinions on other matters prescribed by the Companies Act 2006 which should be headed up as such.

In addition, the four bullet points are matters on which the auditor is required to report by exception and, again, they should not be included within an EoM paragraph.

It is evident from the above that the auditor drafting this auditor's report does not have a sound understanding of ISA (UK) 706. In addition, it is also clear that the audit firm does not have an understanding of when and how an EoM paragraph is used.

1.2 Ensuring the EoM paragraph is technically correct

Remember, an EoM paragraph is only used to cross-reference to a matter that has **already** been adequately presented or disclosed in the financial statements. It is also worth revisiting the technical content of ISA (UK) 706, para 9, which states:

When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall:

- Include the paragraph within a separate section of the auditor's report with an appropriate heading that includes the term "Emphasis of Matter";*
- Include in the paragraph a clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements. The paragraph shall refer only to information presented or disclosed in the financial statements; and*
- Indicate that the auditor's opinion is not modified in respect of the matter emphasized.*

ISA (UK) 706,
para 9

Example – Correct use of an EoM Paragraph

Opinion

We have audited the financial statements of ...

Emphasis of matter

We draw attention to note 34 of the financial statements, which describes the effects of a fire at the premises of a third party warehouse provider. Our opinion is not modified in respect of this matter.

In the above example, the EoM paragraph is correctly headed up 'Emphasis of matter' and correctly cross-refers to the relevant note in the financial statements which describes the issue at hand. The EoM paragraph also correctly indicates that the auditor's opinion is not modified in respect of the fire at the third party warehouse provider.

If the matter had not been adequately described in the financial statements, the auditor could not use an EoM paragraph because they cannot cross-refer to an inadequate disclosure. Instead, the auditor would modify their opinion accordingly because of inadequate disclosure of a material issue. Keep in mind that an EoM paragraph is used to highlight matters in the auditor's report which, in the auditor's professional judgement, are **fundamental** to the users' understanding of the financial statements.

1.3 MURGC paragraphs

MURGC paragraphs are also another issue which seem to have caused an element of confusion.

Where an entity has **adequately** disclosed a material uncertainty related to going concern, this will give rise to the auditor including a MURGC paragraph in the auditor's report. ISA (UK) 570 *Going Concern*, paragraph 22 states:

If appropriate disclosure about the material uncertainty related to going concern is made in the financial statements, the auditor shall express an unmodified opinion and the auditor's report shall include a separate section under the heading "Material Uncertainty Related to Going Concern" to:

ISA (UK) 570,
para 22

- (a) *Draw attention to the note in the financial statements that discloses the matters set out in paragraph 19;*
- (b) *State that these events or conditions indicate that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the auditor's opinion is not modified in respect of the matter; and*
- (c) *For entities that are required, and those that choose voluntarily, to report on how they have applied the UK Corporate Governance Code, or to explain why they have not, a statement that the auditor has nothing material to add or draw attention to in respect of the directors' identification in the financial statements of any material uncertainties to the entity's ability to*

continue to do so over a period of at least twelve months from the date of approval of the financial statements.

What is going wrong?

File reviews often indicate that an audit firm has included references to material uncertainties within an EoM paragraph. This is not technically correct and does not comply with ISA (UK) 570, para 22. Where the entity has adequately disclosed material uncertainties related to going concern, a MURGC paragraph must be used instead.

While the MURGC paragraph acts in much the same way as an EoM paragraph (in that it cross-references to the relevant disclosure note in the financial statements and contains a confirmation that the auditor's opinion is not modified in respect of the matter), it is not the same thing. As going concern is such a fundamental concept, any material uncertainties need to be highlighted and the way to do that through the auditor's report is to use a MURGC paragraph.

In addition, there have been instances where an audit client has made adequate disclosure of a material uncertainty, but no MURGC paragraph has been included in the auditor's report. Indeed, some firms have continued to include the 'Conclusions related to going concern' paragraph which states that based on the work performed, the auditor has not identified any material uncertainties related to events or conditions that, individually or collectively, may cast significant doubt on the company's ability to continue as a going concern for the foreseeable future. This means the auditor's report is inconsistent with the financial statements and indicates a lack of attention on the part of the auditor, or a lack of awareness as to the requirements of ISA (UK) 570.

Example – Correct use of a MURGC paragraph

Material Uncertainty Related to Going Concern

We draw your attention to note 23 which indicates that the company must retender for a large contract in June 2022. If the company were to fail to win the bid, the loss of the contract may have a detrimental impact on the company's operations and cash flows. As stated in note 23, these events or conditions along with other matters as set forth in note 23 indicate that a material uncertainty exists that may cast significant doubt on the company's ability to continue as a going concern. Our opinion is not modified in respect of this matter.

1.4 Inadequate or absent going concern disclosures

If the auditor becomes aware of a material uncertainty related to going concern and the audit client has either made inadequate disclosure or has failed to include any disclosure, the auditor must discuss the issue with the directors. If the directors do not remedy the issue the auditor will have to consider the implications on the auditor's report.

ISA (UK) 570, para 23 states that if appropriate disclosure concerning the material uncertainty is not made in the financial statements, the auditor must:

- (a) express a qualified opinion or adverse opinion, as appropriate, to comply with ISA (UK) 705 (Revised June 2016) *Modifications to the Opinion in the Independent Auditor's Report*; and
- (b) In the Basis for Qualified (Adverse) Opinion section of the auditor's report, state that a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern and that the financial statements do not disclose this matter.

1.5 Key points to remember

EoM and MURGC paragraphs do lend themselves a number of pitfalls which must be avoided. The key points to remember are:

- Not to use an EoM paragraph as a substitute for modifying the audit opinion.
- Cross-reference to the relevant disclosure note in the financial statements when including both an EoM and MURGC paragraph.
- Confirm that the auditor's opinion is not modified in respect of the matter giving rise to an EoM or MURGC paragraph.
- Go back to ISA (UK) 570 or ISA (UK) 706 if there are any issues giving rise to confusion or uncertainty.