

1 **Going concern under review (Lecture A668 – 12.05 minutes)**

In March 2019, the Financial Reporting Council (FRC) issued an exposure draft of *Proposed International Standard on Auditing (UK) 570 (Revised) Going Concern*. This exposure draft contains proposals to enhance the requirements of auditors and the revised ISA (UK) 570 is expected to be effective for audits of financial statements for periods commencing on or after 15 December 2019.

In the UK, financial reporting frameworks require the entity to prepare its financial statements on a going concern basis. The exception to this requirement is where management intend to liquidate the entity, cease trading or there is no realistic alternative to liquidation or cessation of trade. In these circumstances, a basis other than the going concern basis of accounting must be used.

When a company ceases to trade, or there is no realistic alternative to liquidation, many accountants refer to the use of the 'break up basis' of accounting in preparing the financial statements at the reporting date. This basis is inconsistent with FRS 102 and would only be used in very rare circumstances. This is because the entity's financial statements should reflect the circumstances in existence at the balance sheet date. For example, consider a company which has a listed investment, but the reporting entity is ceasing to trade due to difficult trading conditions. It is difficult to see why such an investment should be recorded at an amount below fair value even if it is sold for a lower amount after the balance sheet date. In addition, a loss on disposal of assets which takes place after the balance sheet date is indicative of a decision to hold onto the assets at the balance sheet date rather than sell them at that time. Provisions for future losses would not (and should not) be made if there was no commitment to make such a provision at the balance sheet date.

For these reasons, the financial statements should not usually be prepared on a break up basis but on a basis which is consistent with FRS 102, but amended to reflect the fact that the going concern basis of accounting is not appropriate. This will usually involve the entity writing assets down to recoverable amount and making provisions for contractual amounts which may have become onerous as a consequence of the decision of ceasing to trade.

When management conclude that there are material uncertainties related to going concern but the going concern basis of accounting is appropriate, the entity must disclose those material uncertainties (small entities reporting under FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*, Section 1A *Small Entities* are encouraged to make such disclosures).

1.1 Proposed changes to ISA (UK) 570

Given the fact that auditing has been in the headlines recently for all the wrong reasons, it is to be expected that there will be further revisions to the ISAs (UK) as time goes on. At the time of writing, there was no clear indication from the FRC as to the extent of any changes, although a number of proposals are being considered as part of the various consultations that we have seen in recent months. Clearly something has to be done in order to try and restore public confidence in the auditing profession.

The concept of going concern is a fundamental principle in the preparation of an entity's financial statements. Over recent years, some well-publicised corporate disasters have brought into question why auditor's opinions on these financial statements remained unqualified with no reference made to going concern (e.g. Carillion). The FRC consider that it is in the public interest to propose revisions to ISA (UK) 570 to enhance audit quality.

At the outset it is worth noting that the primary responsibility in assessing whether, or not, an entity is a going concern rests with management of the entity. It is not the auditor's job to determine whether an entity is a going concern or not; it is the auditor's responsibility to obtain sufficient and appropriate audit evidence in respect of management's use of the going concern basis of accounting.

A summary of the proposed key changes to ISA (UK) 570 are as follows:

Linking ISA (UK) 570 to other ISAs (UK)

The exposure draft acknowledges that an ISA (UK) is never applied in isolation, but forms part of the wider suite of auditing standards. For example, providing a link to important principles in other ISAs, such as ISA (UK) 315 (Revised June 2016) *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment*, will better demonstrate how the other ISAs are applied.

Strengthening the objectives of ISA (UK) 570

The exposure draft notes that the objective of the current ISA (UK) 570 is inconsistent with the objectives of some other ISAs (UK), especially where sufficient appropriate audit evidence is concerned. Other ISAs (UK) require the auditor to obtain sufficient appropriate audit evidence, but current ISA (UK) 570 only requires this to be obtained in respect of the appropriateness of management's use of the going concern basis of accounting. The current ISA (UK) 570 does not require the auditor to obtain sufficient appropriate audit evidence in respect of other important aspects, such as whether a material uncertainty exists relating to going concern.

The FRC propose to strengthen the objective of ISA (UK) 570 by requiring the auditor to obtain sufficient appropriate audit evidence about whether a material uncertainty related to going concern exists as well as whether management's use of the going concern basis of accounting is appropriate. This change means there are more robust requirements concerning the nature and extent of audit procedures which the auditor must perform in order to obtain sufficient appropriate audit evidence in these respects.

Enhanced risk assessment procedures and related activities

There are additional requirements which require the auditor to design and perform risk assessment procedures to obtain audit evidence which provides an appropriate basis for the identification of:

- events or conditions which may cast significant doubt on the entity's ability to continue as a going concern; and
- whether or not a material uncertainty relating to going concern exists.

To achieve the above, the auditor must therefore obtain an understanding of the following matters:

- the entity and its environment (paragraphs 10-2(a) to (c));
- the applicable financial reporting framework (paragraph 10-2(d)); and
- the entity's system of internal control (paragraphs 10-2(e) to (h)).

In addition, paragraph 11-1 of Draft ISA (UK) 570 – Revised requires the auditor to carry out additional procedures where the auditor identifies events or conditions which management had not previously identified or disclosed to the auditor.

Obtaining sufficient appropriate audit evidence

There are enhanced requirements in Draft ISA (UK) 705 – Revised in paragraphs 12-1 to 12D-3, including:

- Evaluating management's method to assess the entity's ability to continue as a going concern. This includes a requirement for the auditor to determine if the method selected is appropriate in the context of the financial reporting framework and the auditor's understanding of the entity.
- Evaluating whether changes from the method used in prior periods are appropriate.
- Whether calculations applied in accordance with the method of assessing going concern are mathematically accurate.
- Evaluating the relevance and reliability of the underlying data used to make the assessment.
- Evaluating the assumptions on which management's assessment is based by determining whether there is adequate support for those assumptions and whether they are appropriate in the circumstances.

Professional scepticism and management bias

Draft ISA (UK) 570 – Revised contains a definition of ‘management bias’ as follows: *‘A lack of neutrality by management in the preparation of information.’*

The revised ISA (UK) 570 requires the auditor to carry out more risk assessment requirements (see ‘Enhanced risk assessment procedures and related activities’ above). There is also a requirement to evaluate whether the existence of events or conditions may give rise to the risk of management bias in the preparation of the financial statements. In addition, the auditor is also required to:

- Evaluate whether judgements and decisions made by management in making their assessment are indicators of possible management bias (even if they are individually reasonable).
- ‘Stand back’ and consider all audit evidence obtained to determine if the evidence is corroborative or contradictory when evaluating going concern.

Assessing the viability of the entity in the context of going concern

Draft ISA (UK) 570 – Revised contains paragraphs 16-1 and 24-1 to 24-2 which have been enhanced so they are more aligned with the requirements of ISA (UK) 720 (Revised June 2016) *The Auditor’s Responsibilities Relating to Other Information*. The auditor must perform audit procedures on the viability statement in order to identify material inconsistencies between the viability statement and the auditor’s knowledge obtained in the audit (particularly knowledge obtained during the work performed on going concern).

Appropriateness of disclosures

The terms ‘appropriate’, ‘reasonable’ and ‘adequate’ are used throughout the ISAs (UK) in relation to disclosures. The revised ISA (UK) 570 proposes to align the requirements and application material to the use of the term ‘appropriate’.

Definition of the term ‘material uncertainty’

The description of ‘material uncertainty’ has been moved into the Definitions section of the ISA (UK). Draft ISA (UK) 570 – Revised defines ‘material uncertainty related to going concern’ as:

‘An uncertainty related to events or conditions that, individually or collectively, may cast significant doubt on the entity’s ability to continue as a going concern, where the magnitude of its potential impact and likelihood of occurrence is such that appropriate disclosure of the nature and implications of the uncertainty is necessary for:

- (i) *In the case of a fair presentation financial reporting framework, the fair presentation of the financial statements; or*

(ii) *In the case of a compliance framework, the financial statements not to be misleading.'*

Enhanced reporting

There are enhanced reporting requirements in Draft ISA (UK) 570 – Revised. Paragraph 21-1 states that if the auditor concludes that the going concern basis of accounting is appropriate, a section in the auditor's report headed up 'Conclusions relating to Going Concern' is used which includes:

- An explanation of how the auditor evaluated management's assessment of going concern and, where relevant, key observations arising with respect to that evaluation.
- Where the auditor concludes that no material uncertainty related to going concern has been identified, a statement confirming that the auditor has not identified a material uncertainty related to events or conditions which, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern for a period of at least 12 months from the date on which the financial statements are authorised for issue.
- A conclusion that management's use of the going concern basis of accounting is appropriate.
- For entities which must apply the Corporate Governance Code (or those which choose to do so), they provide a report on how they have apply the Code or to explain why they have not (i.e. a 'comply or explain' concept). The auditor must confirm that they have nothing material to add or draw attention to in relation to the directors' statement in the financial statements about whether the directors considered it appropriate to adopt the going concern basis of preparing the financial statements.

It should be noted that where the auditor concludes that the going concern basis of accounting is appropriate but material uncertainties relating to going concern exist which have been adequately disclosed, the use of a 'Material Uncertainty Related to Going Concern' paragraph will continue to be appropriate.

It should be noted that it is incorrect to include such references to disclosures relating to material uncertainties related to going concern under an Emphasis of Matter paragraph in the auditor's report as is the case under the current ISA (UK) 570 (ISA (UK) 570 – Revised June 2016, para 22).

Strengthening communication with those charged with governance

More emphasis is placed on the communications with those charged with governance where management is unwilling to make or extent its assessment when requested to do so by the auditor.

Communication with regulators

There is a new requirement for the auditor to consider whether there are any requirements beyond ISAs (UK) which would require the auditor to report to a regulatory or other supervisory body when the auditor has determined it necessary to include:

- a 'Material Uncertainty Related to Going Concern' paragraph in the auditor's report; or
- issue a qualified, adverse or disclaimer of opinion in respect of going concern.

Scalability

Specific paragraphs in the application material demonstrate how ISA (UK) 570 is scalable (see paragraphs A3-4, A3-8, A4-1, A4-2, A11-4 and A12).

1.2 Conclusion

Comments on the exposure draft of Draft ISA (UK) 570 – Revised were open until Friday 14 June 2019 and auditors should keep abreast of all developments on the FRC's website to ensure they are up-to-date with planned changes which may affect the work they perform.