FINANCIAL REPORTING COUNCIL EXPOSURE DRAFT – PROPOSED INTERNATIONAL STANDARD ON AUDITING (UK) 570 GOING CONCERN

Response from ICAS to the FRC

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Background

ICAS is a professional body for more than 22,000 world class business men and women who work in the UK and in more than 100 countries around the world. Our members have all achieved the internationally recognised and respected CA qualification (Chartered Accountant). We are an educator, examiner, regulator, and thought leader.

Almost two thirds of our working membership work in business; many leading some of the UK's and the world's great companies. The others work in accountancy practices ranging from the Big Four in the City to the small practitioner in rural areas of the country.

We currently have around 3,000 students striving to become the next generation of CAs under the tutelage of our expert staff and members. We regulate our members and their firms. We represent our members on a wide range of issues in accountancy, finance and business and seek to influence policy in the UK and globally, always acting in the public interest.

ICAS was created by Royal Charter in 1854.

General comments

ICAS welcomes the opportunity to respond to the Financial Reporting Council (FRC) Exposure Draft on Proposed International Standard on Auditing (ISA) (UK) 570 Going Concern.

The issue of going concern has once again come under the spotlight recently as a result of several corporate failures and has again highlighted the role and responsibility of the auditor in relation to the issue. However, we are concerned about the timing of the proposed revision to the standard whilst the Brydon Review is ongoing. It may have been more efficient to wait until the results and recommendations arising from that review were published before proposing any interim revisions to the standard.

Whilst we believe that there is scope for improving audit quality through the introduction of additional audit procedures, we have concerns over their scalability. It is also worth noting that the proposals will also impact on the workload of those in the charity section, particularly charity trustees and charity staff. While some additional effort may be positive for the sector, it is likely to increase the reliance placed on the auditor by these entities in ensuring that charities themselves understand the changed expectations and the steps they need to take to satisfy the auditor.

Furthermore, we would emphasise that, ultimately, the responsibility for the going concern of an entity, and any related reporting, rests with the directors and it is unfortunate that the financial reporting environment is silent on directors' responsibility for reporting on issues related to going concern. This presents a real challenge for the auditing profession as they are frequently perceived and relied upon by the wider public as the persons responsible for highlighting matters related to the going concern of an entity. Whilst we are not aware of any initiatives to address this issue, we believe that there would be merit in the FRC revisiting the Guidance on the Going Concern Basis of Accounting and Reporting on Solvency and Liquidity Risks, to consider whether it should be re-positioned given the recent increased focus on going concern in the UK.

Specific questions

Question 1

Has ISA (UK) 570 been appropriately revised to promote a more consistent and robust process in respect of the auditor's responsibilities in the audit of financial statements relating to going concern? If you do not consider this to be the case, please set out why?

Response 1

We believe that the proposed revisions should contribute towards a better understanding of the auditor's responsibilities in the audit of financial statements relating to going concern. We welcome the introduction of the definition of 'management bias' and a greater emphasis on the need for the auditor to apply profession scepticism, which will include a stand back requirement.

The introduction of enhanced auditor reporting on matters related to the going concern status of an entity should also provide greater insight into the work undertaken by the auditor in evaluating management's assessment of the entity's ability to continue as a going concern.

However, there is a need for greater emphasis on the role of the directors as those primarily responsible for ensuring that the going concern status of accounting remains appropriate therefore, as mentioned previously, there may be merit in the FRC revisiting the Guidance on the Going Concern Basis of Accounting and Reporting on Solvency and Liquidity Risks to consider whether it could be re-positioned given the recent increased focus on going concern in the UK.

Furthermore, we have some concerns about the scalability of the revised ISA under the new proposals. There is a risk that the proposals in the ISA designed to achieve scalability for smaller entities may not be effective and could have a disproportionate impact on the cost of auditing smaller entities. Auditors are required to consider all the requirements regardless of the size of the entity thereby increasing work effort. Where some firms maintain their audit registration to undertake charity audits only, there is a risk that these firms may reconsider continuing their audit registration as a result of the increased work effort, which, in itself, could drive up the cost of an audit for charities. The income condition for audit in Scotland is gross income of £500,000 compared to of £1m in England and Wales which, in itself, is significantly below the income condition for companies (which are not charities).

The wording in the statement of directors'/ trustees' responsibilities could be strengthened around going concern – however, there is no authoritative source which requires such a statement: the current wording has become custom and practice. As part of this exercise, perhaps consideration could be given to how the directors'/trustees' responsibilities could be strengthened and in what manner they could be communicated. One suggestion would be for the FRC to provide illustrative wording for a statement of directors' responsibilities that includes stronger wording on the going concern aspects. Alternatively, the directors' responsibilities wording in the illustrative reports themselves could be strengthened.

Legislation driven by the EU and brought into UK company law has resulted in smaller companies being required to produce very limited disclosures. Disclosures about their going concern status are voluntary, although there is an overall requirement for the accounts to give a true and fair view. Nevertheless, this illustrates a weakness in the accounting framework. This should be addressed before any additional responsibilities are placed on the auditor. This point links to scalability where companies not applying Section 1A of FRS 102 are required to make disclosures about going concern.

Charities have the opposite issue in that they are required to comply with full UK GAAP in order to comply with the Charities SORP (FRS 102). Charities which are smaller entities (under the company law definition) may have simpler business models and therefore naturally have fewer narrative disclosures to make. However, the position is that charities which are smaller entities already have more onerous requirements than companies (which are not charities). In this context, auditors will be in the position of having to require charities to include further disclosures about their going concern status. This is not necessarily a bad thing, but this should really come through as a requirement driven by the accounting framework, not by an auditing standard.

While the Charities SORP-making body can amend the Charities SORP to require trustees to make enhanced disclosures about going concern, including in the trustees' annual report, it would be more appropriate for change to be driven through amendments to FRS 102. Some sector tailoring is likely to be necessary especially in communicating a charity's underlying financial health with reference to its free reserves.

The addition of the following application material is helpful as it emphasises that material uncertainties must be identified and considered in the first instance without reference to mitigating factors. This additional clarity could improve the judgements made by auditors and lead to more candid disclosures in charity accounts:

"A3-1. The auditor's identification of events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern in accordance with paragraph 10-1 is before consideration of any related mitigating factors (i.e., management's plans for future actions in relation to events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern)."

Question 2

Do you believe that the revisions appropriately address the public interest?

Response 2

We agree that the revisions go some way to addressing the public interest perspective but would reiterate that there needs to be greater and clearer articulation of management's role and responsibilities on the issue of the going concern status of an entity.

Question 3

Will the revisions promote a more robust process for:

a) Obtaining an understanding of the entity and its environment, the applicable financial reporting framework and internal control relevant to going concern?

b) Obtaining sufficient appropriate audit evidence in relation to the adequacy of management's assessment

Response 3

We are not convinced that the revisions will promote a more robust process for understanding the entity and its environment, the applicable financial reporting framework and internal control relevant to going concern. Nor do we believe that they will promote a more robust process for obtaining sufficient appropriate audit evidence in relation to the adequacy of management's assessment.

Going concern has been highlighted in many of the FRC Audit Quality Reviews as an area where the work and documentation has been very weak. These weaknesses may arise from the inability of the auditors to obtain sufficient evidence to support the going concern status of the entity. That may be due to some uncertainty around the continuation of future financial support and funding for some entities, particularly in the charitable sector, and therefore the evidence available on which to make a conclusion on the going concern basis of accounting can be limited at best.

Although the revisions promote greater auditor challenge on management's assessment and evaluation of the entity's ability to continue as a going concern, there is no related requirement within the financial reporting framework that requires such a robust and rigorous assessment and evaluation by management on the issue of going concern. The absence of such a requirement is a challenge for auditors ensuring that the same rigour is applied by management in their going concern assessment and, as a result, the auditor often finds it difficult to reach a conclusion on the going concern status of the entity.

Question 4

In making an assessment of going concern, management are required to consider a period of at least 12 months. In evaluating management's assessment should the auditor be required to consider a longer period, and if so, what should it be?

Response 4

We do not believe that the auditor should be required to consider a period longer than that considered by management when evaluating their assessment of going concern. This will reinforce the point that it is the directors who have the ultimate responsibility for assessing and determining the entity's going concern status. The auditors should have no additional responsibilities in this respect.

Question 5

Is it sufficiently clear from the revisions to the standard that the auditor is required to first identify whether there are events or conditions that may cast significant doubt on the entity's ability to continue as a going concern before considering whether there are factors which may mitigate those events or conditions?

Response 5

We agree that the proposed revisions introduce some clarification to the standard that the auditor is required to first identify whether there are events or conditions that may cast significant doubt on the entity's ability to continue as a going concern before considering whether there are factors which may mitigate those events or conditions.

Question 6

Do the proposals sufficiently support the appropriate exercise of professional scepticism throughout the risk assessment procedures, evaluation of management's assessment and evaluation of audit evidence obtained?

Response 6

We welcome the introduction of enhanced guidance around the need for the auditor to exercise appropriate professional scepticism over management's assessment of going concern. Although we do have concerns that this will ultimately lead to the need for greater documentation around this process adding to the auditor's workload. For audits of smaller entities and those in the charitable sector this additional workload may be disproportionate.

Question 7

Do you agree with the proposals for auditors of all entities to provide an explanation of how the auditor evaluated management's assessment of going concern (including key observations) and to conclude on going concern in the auditor's report?

Response 7

As stated in our response to question 1, we have concerns around this increased reporting responsibility in the charitable sector and parts of the SME sector. In many of the entities in these sectors, the available evidence may be limited at best and therefore, the auditor's assessment may be difficult to articulate succinctly and conclusively, without raising some questions over the appropriateness of the going concern basis.

We believe that a requirement for enhanced disclosures around management's evaluation of the going concern status should be introduced and the auditor should then report on that assessment in his/her report. It should not be the responsibility of the auditor to introduce new information about the entity's ability to continue as a going concern in the auditor's report.

Question 8

Are the requirements and application material sufficiently scalable, including the ability to apply ISA (UK) 570 (Revised) to the audits of entities with a wide range of sizes, complexities and circumstances?

Response 8

As stated in our responses to questions 1 and 7, we are concerned about the scalability of the proposed revisions, particularly for those entities in the charitable sector and smaller entities. These types of entities do not possess the more sophisticated internal controls present in larger and more complex entities. There is also greater uncertainty around future funding in smaller entities and in the charitable sector and therefore any supporting information and evidence may be limited.

We do acknowledge that these entities play a vital role in both the economy and in the public interest and therefore should be expected to make some commentary around their ability to continue as a going concern. However, we believe that the responsibility for the inclusion of this commentary should rest with the directors/trustees and that the auditor should refer to that commentary in his/her report.

Also, with regard to pension scheme audits, it is adaptability of the going concern concept that is an issue for such audits. The concept of going concern is already stretched in relation to pension scheme accounts, which are stewardship accounts. This tension has been addressed in the Pensions SORP through its interpretation of the going concern concept for pension schemes so that trustees, accounts preparers and auditors can deal with this issue in a consistent and sector appropriate manner.

The Pensions Research Accountants Group further addressed the challenge of applying this concept by issuing good practice guidance on 'Pension scheme financial statements and going concern (April 2018)' which includes guidance on the application of extant auditing standards.

As a minimum, we would recommend that the revised ISA (UK) 570 on going concern addresses the question of the adaptability of the concept of going concern to pensions schemes, and that consideration is given to providing related illustrative auditor's report wording. Illustrative wording would be especially valuable for the auditors of smaller schemes.

Question 9

Do you agree with the proposed effective date (aligned to the effective date of ISA (UK) 540 (Revised December 2018)?

Response 9

The proposed effective date would appear to be appropriate to align with that of ISA (UK) 540 (Revised).

Question 10

Do you agree with the withdrawal of Bulletins 2008/1 and 2008/10 as set out in paragraph 1.20? Is there guidance in these Bulletins which has not been included in the revised standard which remains useful and should be included?

Response 10

We agree with the withdrawal of Bulletins 2008/1 2008/10 as that guidance was issued during the financial crisis and addressed very specific issues that arose during that period of economic uncertainty.

Question 11

What mechanisms should the FRC employ to ensure there is widespread awareness of the Director's responsibilities in respect of going concern?

Response 11

As we have highlighted throughout our response, there is a need for greater emphasis and amplification around the role and responsibilities of management in respect of going concern. This might be best served by greater clarification within the financial reporting frameworks on what is required to be considered when adopting the going concern basis of accounting and articulation of what would be considered acceptable as part of management's assessment and evaluation of the going concern status of the entity.