Financial Reporting Council

Head of audit
ABC LLP

24 November 2020

Dear Sir/ Madam

FRC's review of firms' audit of going concern assessments

I am writing to give feedback on our review of the audit of entities' going concern assessments, on a sample of **eleven audits**. This covered the **seven largest UK audit firms** and considered whether the policies and procedures that the firms implemented earlier in the year (to respond to Covid-19 related risks) had been put into practice effectively. We commented on these enhanced procedures in our letter sent to you on 29 June 2020: https://www.frc.org.uk/getattachment/953261bc-b4cb-44fa-8566-868be0ff48dc/FRC-going-concern-review-letter.pdf

Our review covered completed financial statement audits, rather than interim review procedures, and focused on audits completed after the update of the firm's audit procedures previously reviewed by us. The audits ranged from December 2019 to March 2020 year ends, and the financial statements were approved between March and June 2020, after Covid-19 had an impact.

Both of these reviews follow the guidance for companies, and bulletin for auditors, issued by the FRC in March 2020, and subsequently expanded to cover additional matters: https://www.frc.org.uk/news/march-2020-(1)/frc-guidance-for-companies-and-auditors-during-cov and the FRC's thematic report on Covid-19 related disclosure, published in July: https://www.frc.org.uk/getattachment/03838acd-facc-4a06-879c-a4682672a6d7/CRR-COVID-19-Thematic-Review-Jul-2020.pdf

While the Board of the relevant entity is responsible for the going concern assessment, auditors are required to audit it in accordance with ISA (UK) 570 Going Concern, and firms need to ensure there are appropriate policies and procedures in place for this.

Some of our key findings are also relevant to other areas of the audit, given the broad impact of Covid-19 on many businesses, as well as to those audit firms that were not included within the scope of our review.

Key findings

- In our letter issued in June, we explained that the firms had enhanced their audit policies and procedures relating to going concern from the end of March 2020, when the consequences of Covid-19 began to increase the risk of material uncertainties relating to going concern for many entities. In our review of a sample of completed audits, **these enhanced policies and procedures had been substantially applied in practice**.

- There was **evidence of an appropriate level of challenge** by the auditors, and this was confirmed through our communications with the Audit Committee Chairs of the relevant entities, who informed us that the auditors had challenged management's going concern assessment appropriately.

- The audits had a **good level of consultation**, in line with the enhanced requirements of the firms, and this contributed positively to the quality of those audits. Some of the audits had adopted more enhanced consultations than others, such as technical panels, reflecting the requirements of the specific firm. However, some of the audits had insufficient evidence of the consultations that took place (key finding 1 below).

- The auditors applied a risk-based approach, with consideration of the reasonableness of the key assumptions proportionate to the risks of the relevant entity. **The economic scenarios were tailored to the entities' circumstances, rather than using standard anchor scenarios** (key finding 2). Specialists were often used to assess the appropriateness of the assumptions, in particular for funding arrangements (key finding 8).

- The **use of reverse stress testing** and consideration of other severe, but plausible, scenarios assisted the auditors' consideration of potential material uncertainties (key finding 3). There was an **appropriate consideration of disclosures for material uncertainties**, except in one case, where we found insufficient challenge in this respect (key finding 5).

- An area for improvement was the consideration of **the going concern assessment period,** which we found was not always clear, in cases where it went beyond a year from the date of the approval of the financial statements (key finding 4).

- Another area for improvement was the **testing of the integrity of the forecasting models** (key findings 6) where there was an inconsistent approach taken.

- The audit work was **performed in line with the requirements of ISA (UK) 570** and followed the additional guidance issued in March 2020 by the FRC. The enhanced workpapers required by the firms helped to evidence this (key finding 7). Some firms had also used this situation as an opportunity to incorporate into their guidance certain aspects of revised ISA (UK) 570. Firms will be enhancing their policies and procedures further to comply with the revised standard, which comes into effect for December 2020 year ends.

- **In view of the continuing impact of Covid-19, the need for a robust assessment of going concern by the auditors continues to be as important as ever.** Firms should, therefore, continue implementing the good practices in forthcoming audits, and focus on specific areas for improvement, as detailed in the appendix to this letter.

Yours sincerely

David Rule
FRC Executive Director of Supervision

Appendix
Key findings by area

1) There was an appropriate level of consultation, which improved the extent of challenge by the auditors

Background
All firms enhanced their consultation requirements on going concern assessments at the end of March 2020. The consultation process provides additional support to the auditors in ensuring that there has been a sufficiently robust approach, particularly when considering a material uncertainty in relation to going concern.

Findings
The audits we reviewed followed the firms' range of consultation procedures, being:
- Technical panel (comprising senior audit partners)
- Central technical review (usually a mix of audit partners and directors/managers in a central technical team), or
- Reviews by an additional audit partner (not a technical expert, but a peer)

We found that the audits had a good level of consultation, in line with the enhanced requirements of the firms. In all cases, the auditors compiled a summary evaluation for consideration in the consultation process, which helped prompt them to consider the extent of evidence needed from the perspective of an independent reviewer, and also encouraged them to pre-empt some of the challenge provided in the consultation process.

In three of the firms, where the firms' policies did not mandate a technical panel, the consultation procedures involved a central technical, or second partner, review. We found insufficient evidence of the consultations that took place in some of these cases:
- On two audits, while the consultation process was concluded, there was no evidence of the matters discussed in the consultation process to arrive at the conclusions.
- On another audit the write up of the consultation was not as detailed as on another audit at the same firm, which had undertaken a technical panel review.

Good practice examples
Where technical panels had been held, there was often good evidence of the discussions, as well as the challenges and requests made to the audit team and the conclusions reached, through the minutes of the panels.

On two audits we found that the auditors provided further challenge to management as a direct result of the technical panels. In both cases, this led to management re-running further scenarios and stress testing.

Two other audits went beyond the required consultation procedures of the relevant firm, by requesting a technical panel to provide a further level of review, due to the judgments involved, and this improved the extent of challenge by the auditors.

2) The economic scenario-related assumptions were tailored to the specific risks of the entity

Background
For many entities, assumptions about the period of lockdown and the speed of economic recovery were key to the going concern assessments. Depending on the strength of the balance sheet and availability of cash resources and other facilities, these assumptions can be critical in determining whether there is a material uncertainty.

Findings
The auditors applied a risk-based approach, with consideration of the reasonableness of the key assumptions proportionate to the risks of the relevant entity.

None of the audits used standard “anchor scenarios” on the economic forecasts or other assumptions, such as the impact on future trading. Appropriately, the auditors recognised that assumptions should differ depending on the circumstances of individual entities, for example the sectors and geographical regions they operate in.

Good practice examples
One firm provided useful guidance on the assumed periods of trading, including a rebuttable presumption that all audit teams should assess a six-month period of no trade in the initial lockdown period. In both of the audits we reviewed at that firm, this assumption was rebutted based on reasonable explanations, with a tailored approach taken to the forecast impact on trading.

In two audits the auditors’ assessment included reviewing management’s evaluation of historical data from the previous financial crisis, to assist in the assessment of the economic impact on the business in the forecasts and the reasonableness of the scenarios developed.

In most cases the auditors’ obtained market relevant data to assist them in assessing managements forecast scenarios. At one firm, the central research team provided the audit teams with weekly bulletins on sector specific developments, including news articles, broker reports and share price movements. In two other firms, the auditors used macro-economic outlook information, which was provided by their in-house economists, to challenge management on their assumptions.

3) Reverse stress and scenario testing assisted in the assessment of whether there was a material uncertainty

Background

ICAEW guidance states that "a reverse stress test is a stress test that starts from the opposite end, with the identification of a pre-defined outcome. This might be the point at which an entity can be considered as failing, or the entity's business model becomes unviable. Severe, but plausible, scenarios that might result in this outcome are then explored".

The guidance issued to companies by the FRC in March 2020 stated "Many companies already use scenario and stress testing in developing their statements and this should continue as far as practicable. The use of reverse stress testing, to identify future scenarios that could lead to corporate failures, is also good practice".

These techniques are particularly useful in assisting with the assessment of whether there is a material uncertainty, given the increased uncertainty in a situation such as Covid-19. While a reverse stress test provides a "break" scenario, management and the auditors may also need to consider what is a severe, but plausible, scenario.

Findings

We found that reverse stress testing was used on most of the audits we inspected. On the audits we reviewed, management had often also prepared a:

- Covid-19 base-case;
- A downside scenario; and
- A severe but plausible downside scenario (based on the individual entity's risks).

The cases where a reverse stress test was not used were on:

- Two of the audits, which were businesses operating in sectors which were vulnerable to Covid-19 and where management had already concluded that there was a material uncertainty over going concern.
- Another audit, where the business sector was less exposed to the economic shock of Covid-19, and therefore reverse stress testing was not necessary.

On two audits there was insufficient consideration as to whether the actions identified by management of the audited entity were achievable or sufficient to mitigate the impact of the stress testing. On one of these audits, the actions included the raising of new funds, which were also intended to complete an acquisition, however the updated cashflow forecasts did not factor in the cost of the acquisition.

Good practice examples

On five of the audits the auditors performed an appraisal of the principal business risks and how they would affect the business model. They were then able to use this to evaluate the severe but plausible downside scenario for reasonableness. In one case the auditor also reviewed the audited entity's risk register to consider whether there were any factors that had been overlooked by management in their scenario planning.

Where relevant, the auditors considered what the emerging trading pattern started to look like during the UK lockdown restrictions, before the approval of the financial statements, and compared these to the severe but plausible scenarios prepared by management.

4) The length of the going concern assessment period was not always clear in cases where it went beyond a year

Background
ISA (UK) 570 states that the period used by management in making their going concern assessment is usually at least one year from the date of approval of the financial statements. However, management may need to go beyond this one year period, due to events that need to be considered in later months, such as re-financing. ISA (UK) 570 goes onto say that, in evaluating management's assessment of the entity's ability to continue as a going concern, the auditor shall cover the same period as that used by management to make its assessment.

Findings
On two audits, where the period used by management to assess going concern was longer than a year from the date of approval of the financial statements, the disclosures and auditor's report were not clear as to the period of the going concern assessment, with them referring to "…a period of at least twelve months from the date of the financial statements". We have also identified similar matters on other audits we have reviewed this year (as part of the wider AQR inspection of audits, outside this sample), where it was also unclear as to the period of the going concern assessment.

Where management has assessed going concern over a period that is longer than a year from the date of the date of approval of the financial statements, the auditors should ensure that their audit procedures cover that same period and that the disclosures in the financial statements and the auditor's report clearly state the period of the going concern assessment.

Good practice examples
There were examples where the auditors had appropriately assessed the going concern period used by management, which included:

- A consideration of whether the going concern period would capture a full business cycle; and/or
- Whether there were any events and circumstances within the period that may have required a period of more than the minimum twelve-month period.

5) While the consideration of the disclosures for material uncertainties was generally appropriate, there was insufficient challenge on one audit

Background

ISA (UK) 570 requires an assessment of the adequacy of disclosures where events or conditions have been identified that may cast significant doubt on the entity's ability to continue as a going concern. Where a material uncertainty exists, clear disclosures are required to explain the nature of the material uncertainty and the events and circumstances that have led to it.

Findings

On one audit the uncertainty over funding arrangements for the entity resulted in management concluding that there was a material uncertainty over going concern. The auditor recommended disclosure improvements to management and the Audit Committee (including the maximum cash flow requirement, timing of the need for cash and the details of the expected funding), to ensure there was sufficient information about the extent and nature of the material uncertainty. However, management did not amend the disclosures for these matters. The auditor should have challenged management further over the adequacy of the disclosures, (given the lack of clarity over the assumptions underlying the different scenarios that management had used and as to how those assumptions had been sensitised) and should have considered enhanced disclosures within the going concern section of the auditor's report.

Good practice examples

In most cases the auditors appropriately considered and challenged the adequacy of the disclosures for the going concern assessment, including as part of the consultation process. We found examples of good disclosures which were tailored specifically to the circumstances, and clearly explained the scenarios and assumptions that management had used in their going concern assessment and the nature of the material uncertainties, where relevant. The additional consultation procedures helped in this respect.

6) There was an inconsistent approach to testing the integrity of the going concern forecast models

Background

Management's going concern assessment will often need to use a cash flow forecasting model in arriving at the level of forecast headroom for cash requirements and covenants, and these are also used to run different scenarios and perform sensitivity analysis.

Findings

In most cases the auditors performed procedures to check the integrity of the going concern cashflow forecast model. These procedures were often focused on reperforming a sample of calculations within the model to check the mathematical and mechanical accuracy, as well as verifying that the opening liquidity and working capital positions were correctly stated. In most cases, the auditors also performed procedures to establish management's historical budgeting accuracy was within an acceptable range.

On one audit the integrity of the forecasting model was not adequately tested. The historical budgeting accuracy testing found that management's forecasting track record was unreliable, however the auditor did not perform further procedures to respond to this increased risk of forecasting inaccuracy. On another audit there was insufficient evidence of the testing of the forecasting model. On two further audits the audit procedures were limited to manual testing; the approach would have been enhanced by the use of automated spreadsheet tools.

Good practice examples

Given the complexity of the models, some audits also used data analytical procedures, including Computer Aided Audit Techniques ("CAATs"), to test the integrity of the cash flow models. In particular, on three audits, we found that the use of specific tools to check the mathematical and mechanical accuracy of the models highlighted matters such as circular references, formulaic anomalies and hidden cells/input fields.

In some cases, the auditors had engaged specialists to assist in checking the integrity of the forecasting models.

There were also examples where the auditors performed detailed procedures to ensure the cash flow forecasts used to assess going concern were consistent with those used in the entity's impairment model.

7) Enhanced work papers assisted in evidencing the key aspects of the going concern assessment

Background
The firms updated their going concern work programs (and papers) at the end of March 2020 onwards, generally by supplementing them with additional work programs, templates, practice aids or checklists. The firms informed us that a supplemental approach was necessary, given many audits were either in progress or nearly completed at the time of the changes, and also that the updates relating to the revised ISA (UK) 570 did not come into effect until the end of 2020 (and further updated work programs would need to be issued for this).

The FRC's Covid-19 related guidance, issued in March 2020, stated that "when performing an audit for which the revised standard is not yet effective, auditors may consider using some or all of the requirements in the revised standard to help them to carry out their risk assessment and to undertake their work in this area to the necessary high standard". Some firms had used this situation as an opportunity to incorporate into their guidance and work programs certain aspects of revised ISA (UK) 570.

Findings
In the audits we reviewed the required work programs and work papers were substantially used in practice.

Good practice examples
On most of the audits we found well-constructed work papers on going concern that included the:

- Risk assessment, including the entity's funding and liquidity position;
- Planned audit approach to going concern;
- Audit evidence obtained, including work performed on the forecast cash flow models, the key assumptions, stress testing and an assessment of any mitigating actions;
- Cases of challenges of management;
- Assessment of the adequacy of disclosures;
- Consultations that had taken place and the results of those consultations;
- Conclusions of the work performed; and
- Any implications for the audit opinion.

On two audits the auditors also prepared a memorandum that explained how their work had evolved, and how they dealt with emerging factors such as developments in management's own strategy.

8) There was often good use of specialists

Background
Internal specialists, such as transactions advisory, business recovery and economists, can contribute to the quality of the auditor's going concern assessment, through their expertise in assessing the cash-flow forecast assumptions, including the ability to raise further funds.

Findings
On six of the audits, the audit teams used internal specialists to assist in their evaluation of the going concern assumption, which had an overall positive impact on the audit. Specialists were also used as a basis of providing additional challenge to management.

Good practice examples
In three cases the entities were in the process of raising additional funds, which required a working capital assessment. The audit teams used the work performed by the transaction advisory team as part of their assessment. These audit procedures included obtaining and critically appraising the working capital report (prepared by the reporting accountants), reviewing minutes of discussions held with the transaction advisory team and discussing with management and the reporting accountants any differences between their respective findings.

On another three audits several different specialists were used to assist in assessing and challenging the forecast assumptions prepared by management.