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Hermes Investment Management and Hermes EOS - Response to the Proposed International Standard on Auditing (UK) 570 (Revised) Going Concern Exposure Draft

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About Hermes Investment Management
Hermes Investment Management is an asset manager with a difference. Our purpose is helping beneficiaries retire better by providing world class active investment management and stewardship services. With £34.1 billion[1] in assets under management, we focus on holistic returns – outcomes for our clients that go far beyond the financial – and consider the impact our decisions have on society, the environment and the wider world. Our stewardship team, Hermes EOS, is one of the world's leading engagement resources, advising on £450.5 billion[2] on behalf of over 40 international institutional investors. The views expressed in this communication are those of Hermes EOS and do not necessarily represent the views of all clients.

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?**

We are supportive of the proposed changes and agree that they promote a more robust process regarding the audit of financial statements relating to going concern. The strengthening of the auditor's responsibility so that sufficient appropriate audit evidence is obtained regarding whether a material uncertainty exists related to going concern brings it into line with the level of challenge required by other ISAs.

[1] Source: Hermes as at 31 March 2019. Please note the total AUM figure includes £6.5bn of assets managed or under an advisory agreement by Hermes GPE LLP ("HGPE"), a joint venture between Hermes Fund Managers Limited ("HFM") and GPE Partner Limited. HGPE is an independent entity and not part of the Hermes group. £23.4m of total group AUM figure represents HFM mandates under advice.
[2] Source: Hermes as at 31 March 2019

2. **Do you believe that the revisions appropriately address the public interest?**

We are supportive of the increased challenge required in relation to going concern, as this provides important insight to the wider group of stakeholders that would be impacted by a company's failure.

In *The Sun Also Rises*, Ernest Hemingway writes:

"How did you go bankrupt?"

"Two ways. Gradually, and then suddenly."

It is rare that a company ceases to be a going concern as a consequence of a single unforeseeable shock. More often, this point will have been reached as a result of a series of decisions that lacked prudence, were over-optimistic or in some way failed to acknowledge the reality of the company's situation.

For this reason, we would like to see auditors' obligations clarified so that they have in mind a possible future going concern issue and its potential impact on items such as unrealised profit and treatment of goodwill. That is why we would like to see broader changes to the guidance on how IFRS is interpreted in the UK, in order to bring accounting standards into line with company law. As such, we are strongly in favour of the use of prudence as an underlying principle in preparing and auditing accounts. We would therefore like to see prudence also applied to the judgement of underlying assumptions that feed into a company's status as a going concern.

We recognise that certain factors that may raise questions about the company's long-term viability may not have a material impact in the time period under examination, which may be only twelve months. For example, oil companies often use an optimistic oil price in their calculations of future revenues which may still be considered still within the bounds of 'reasonable', whereas we would like to see a 'prudent' view taken. We are therefore in support of the use of graduated findings, which may allow elaboration on the auditor's view of whether the assessment of a company's status as a going concern is 'prudent' or only 'reasonable', and would advise that auditors consider potential material events that may impact an entity's going concern status over a longer time period.

ED ISA (UK) 570 10-4 states that auditors should 'inquire of management as to its knowledge of events or conditions beyond the period of management's assessment that may cast significant doubt on the entity's ability to continue as a going concern' and evaluate the potential significance of such an event on the entity's ability to continue as a going concern. Auditors are required to evaluate whether such events may give rise to a risk of management bias in the preparation of financial statements. We would encourage reporting of any such considerations and any resulting debate and decision-making process. We support the requirement that in the event of the identification of material uncertainties, auditors should request management perform additional procedures to understand the effect of the events or conditions on management's going concern assessments.

In particular, auditors should be aware that is their duty (as is now included at ED ISA (UK) 570 18-1) to search not only for evidence that may corroborate management's view but also to search for contradictory evidence so that management's view can be appropriately challenged and tested.

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?**

Yes. Obtaining an understanding of the business model, objectives and strategies is extremely important to evaluating management's going concern assessment. Assessing internal controls can provide increased confidence in the entity itself to shareholders and other users of accounts. By seeking additional evidence in relation to going concern, in particular whether a material uncertainty exists and how management have made their assessment, we would expect auditors to have a deeper understanding of the entity they are auditing. This will be supported by the requirement that auditors evaluate whether assumptions used in the going concern assessment are consistent with those used in other areas of the business' activities. In particular, we welcome the requirement to perform procedures on the viability statement in order to identify material inconsistencies between the viability statement and going concern assessment, along with other areas of the audit.

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

We would encourage the auditors to consider a period beyond 12 months. The exact length of time it is possible to consider will vary between businesses, but where there are issues evident that may impact the viability of the company in future years, this should be reported. For instance, in the example given above, if an oil company's viability would likely be significantly impacted by a permanently lower oil price, it would be of value to raise this in the audit report. This is part of a wider question about the purpose of audit and whether it should be more forward-looking, which is within the scope of the ongoing Brydon Review. It would also be made easier by the use of graduated findings, so that auditors could raise concerns without being required to provide a modified opinion on the entire set of financial statements.

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?**

Yes, we believe this is sufficiently clear.

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?**

Yes. We are supportive of the requirement that auditors obtain sufficient evidence to make their own assessment of going concern and in particular of ED ISA (UK) 570 12D-3, which states that auditors should use professional scepticism throughout the audit and especially 'when reviewing future cash flow relevant to the entity's ability to continue as a going concern.' As discussed above, we believe that there are risks to a company using only optimistic figures for its forecasts, and not testing scenarios in which certain factors are less favourable. The increased risk assessment requirements and assessment of potential management bias should also support increased professional scepticism.

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?**

Yes, we believe that this should be applied to audits of all entities. If there is sufficient evidence for management to make the going concern assessment, we would expect there to be sufficient evidence available to the auditor to evaluate this assessment, regardless of the size or nature of the entity.

The report should disclose how management have made their assessment, the risks, mitigants and sensitivities they have used and how the auditor has assessed and challenged management’s conclusions.

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?**

It is important that the workload is proportionate and to bear in mind that the key determinant is likely to be complexity, rather than scale. If this cannot be achieved, the risk is that we will end up with another layer of boilerplating. Whilst the proposed revisions are not unduly prescriptive, we suggest additional emphasis on the requirement that auditors are expected to consider whether there is contradictory evidence and not just corroborative evidence for managements opinion.

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

Yes, we agree with the proposed effective date.

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

We would advise the FRC to issue guidance to both Directors and auditors after the publication of the revised ISA (UK) 570, in order to clarify the roles and responsibilities of each in the assessment of the entity‘s status as a going concern.