Consultation

Financial Reporting Council

March 2019

# Proposed International Standard on Auditing (UK) 570 (Revised) Going Concern

# Exposure Draft

The Financial Reporting Council (FRC) is the UK's independent regulator responsible for promoting high quality corporate governance and reporting to foster investment. The FRC sets the UK Corporate Governance and Stewardship Codes and UK standards for accounting and actuarial work; monitors and takes action to promote the quality of corporate reporting; and operates independent enforcement arrangements for accountants and actuaries. As the Competent Authority for audit in the UK the FRC sets auditing and ethical standards and monitors and enforces audit quality.


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The FRC's mission is to promote transparency and integrity in business. The FRC sets the UK Corporate Governance and Stewardship Codes and UK standards for accounting and actuarial work; monitors and takes action to promote the quality of corporate reporting; and operates independent enforcement arrangements for accountants and actuaries. As the Competent Authority for audit in the UK the FRC sets auditing and ethical standards and monitors and enforces audit quality.


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# Contents

*Page*

## Introduction

1. The FRC is committed to acting as a proportionate and principles-based regulator and balances the need to minimise the impact of regulatory requirements on business, while working to support the delivery of high-quality audit and assurance work to maintain investor and wider stakeholder confidence in audit.

2. In developing the proposals which are the subject of this consultation, the FRC has continued to seek to:

   - develop a clear and sustainable framework and clear lines of accountability (so that companies and audit firms know the exact role of all UK regulatory bodies);
   - maintain market confidence in the independence of regulation (so that investors and potential investors remain confident in the quality of financial statements);
   - apply the rule of proportionality, and deliver implementation that can be justified and defended; and
   - serve the public interest.

   This consultation is based on the current requirements in Company Law and in Accounting Standards in respect of going concern. It does not propose changes which require any change to that framework. Those matters are for consideration by Sir Donald Brydon's review of the Future of Audit. Audit matters relevant to standards other than going concern, will be covered through the FRC post implementation review of the 2016 Auditing and Ethical Standards.

> The financial reporting frameworks applicable in the UK generally require the adoption of the going concern basis of accounting in financial statements, except in circumstances where management intends to: liquidate the entity; to cease trading; or has no realistic alternative to liquidation or cessation of operations. In effect, an entity that does not meet the threshold for that exception is described as a going concern. This requirement applies even when there are uncertainties about events or conditions that may cast significant doubt on the entity's ability to continue as a going concern in the future. Such uncertainties are required to be disclosed in the financial statements when they are material.

3. Going concern is one of the fundamental principles in the preparation of financial statements. In essence, a company that is a going concern is one which has the resources needed to continue operating for the foreseeable future. The collapse of large companies such as HBOS, BHS, and Carillion has brought into question why such companies had clean auditor's opinions, which included no warnings that the companies were at risk of collapse. Some enforcement cases conducted by the FRC also found issues related to going concern, (e.g. AssetCo Plc) raising further concerns about the effectiveness of auditors work on going concern.

4. The audit requirements in respect of going concern are set in out in International Standard on Auditing (UK) (ISA (UK)) 570 (Revised June 2016) *Going Concern*. In addition, there are two Bulletins which contain guidance for auditors on going concern as follows:

   - Bulletin 2008/1 *Audit issues when financial market conditions are difficult and credit facilities may be restricted* (January 2008)

- Bulletin 2008/10 *Going concern issues during the current economic conditions* (December 2008)

5. The International Standards on Auditing (ISAs) UK are based on the corresponding international standards issued by the International Auditing and Assurance Board (IAASB). Where necessary, the international standards are augmented with additional requirements to address specific UK legal and regulatory requirements; and additional guidance that is appropriate in the UK national legislative, cultural and business context.

6. The IAASB last revised ISA 570 (Revised) in January 2015 to incorporate additional reporting requirements as a result of the IAASB's Auditor Reporting project,[1] and those changes were incorporated into the corresponding UK standard in June 2016. At the same time as these revisions were made, the FRC added further requirements to the standard requiring UK auditors to report by exception on whether:

    - The going concern basis of accounting is not appropriate; and

    - Identified material uncertainties have not been disclosed in the financial statements.

7. However, it has been some time since ISA (UK) 570 has been revised significantly and there are no current plans for the IAASB to commence a project to revise the equivalent international standard which could subsequently be adopted in the UK. Given the fundamental importance of going concern in a set of financial statements and the findings arising from a number of the FRC's enforcement cases, the FRC believes it is in the public interest to now propose revisions to this standard with the view to driving necessary improvements in audit quality. In strengthening ISA (UK) 570 to enhance audit quality, we sought to deliver the revisions working to achieve the following outcomes in the public interest:

    - **Fostering an appropriately independent and challenging mindset of the auditor** – Professional scepticism is a fundamental concept and core to audit quality, an important outcome is to reinforce the application of professional scepticism when challenging management's assessment of going concern.

    - **Transparency** – to provide investors and other stakeholders (such as those charged with governance) with greater insight into the audit process through enhanced auditor reporting.

    - **Enhancing documentation of the auditor's judgments** – The audit file should appropriately demonstrate the auditor's decision-making processes, including essential interactions and key judgments made.

    - **Keeping ISAs (UK) fit for purpose** – the ISAs (UK) should contain robust requirements and guidance to drive appropriate engagement partner and engagement team performance, regardless of the circumstances.

    - **Reinforcing the need for robust communication and interactions during the audit** – Strengthen interactions between engagement partners, their teams as well as communications with those charged with governance.

8. The project to revise ISA (UK) 570 is one element of a wider programme of FRC activities, including supporting the work of the Competition and Markets Authority review

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[1] http://www.iaasb.org/projects/auditor-reporting

of the UK audit market, Sir John Kingman's consideration of audit procurement, and a review of the future scope of audit to be led by Sir Donald Brydon. Work on the future scope of audit will focus on those issues that cannot be addressed through changes to standards alone and will also align with the FRC's project on the future of corporate reporting.

9. In addition, in November 2018, the FRC issued a call for feedback as part of the Post Implementation Review of the Ethical and Auditing Standards issued in 2016. That call for feedback also included a question on going concern.[2]

[2] Post Implementation Review 2016 Ethical and Auditing Standards – Call for Feedback, question xix: For going concern, auditors are required to assess whether management's use of the going concern basis of accounting as required by IFRS or UK GAAP is appropriate. How could auditors make their assessment of greater value to users of financial statements? Please set out what steps you believe should be required to better underpin confidence in audit and audited financial statements.

# Explanation of proposed key changes

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

1.1 Whilst ISA (UK) 570 deals with the auditor's responsibilities in the audit of financial statements relating to going concern, an ISA (UK) is never applied in isolation, but instead forms part of the wider suite of auditing standards. We believe that enhancing the links from ISA (UK) 570 to important principles in other ISAs (UK), will better demonstrate how the other ISAs, in particular, ISA (UK) 315 (Revised June 2016)[3], are applied in respect of the auditor's responsibilities in the audit of financial statements related to going concern, and provide an improved basis for the evaluation of management's assessment of the entity's ability to continue as a going concern.

## Strengthening the objectives of ISA (UK) 570

1.2 The objective of ISA (UK) 570 is inconsistent with the objectives of some other ISAs (UK). In particular, in other ISAs (UK) the auditor is required to obtain sufficient appropriate audit evidence. ISA (UK) 570 only requires sufficient appropriate audit evidence to be obtained on the appropriateness of management's use of the going concern basis of accounting, but not in respect to other important aspects of going concern, including whether a material uncertainty exists related to going concern.

1.3 As the going concern assumption is a fundamental principle in the preparation of financial statements, the auditor must obtain sufficient appropriate audit evidence about whether a material uncertainty related to going concern exists; and management's use of the going concern assumption is appropriate. We have, therefore, revised the objectives of the standard (see ED ISA (UK) 570 paragraph 9) and strengthened the requirements and application material to support the revised objectives. In particular, there are more robust requirements regarding the nature and extent of procedures that the auditor should perform to obtain sufficient appropriate audit evidence about whether a material uncertainty related to going concern exists and management's use of the going concern basis of accounting is appropriate (see ED ISA (UK) 570 paragraphs 12-1 and 12-2).

## Enhancing the risk assessment procedures and related activities

1.4 The standard has been enhanced to draw clearer links between the auditor's responsibilities in respect of going concern and the auditor's understanding of the entity and its environment, the applicable financial reporting framework and the entity's system of internal control in accordance with ISA (UK) 315. This will drive the auditor to obtain information that is relevant to the identification of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and whether a material uncertainty related to going concern exists. In particular:

- ED ISA (UK) 570 Paragraph 10-2(a)–(c), requires the auditor to obtain an understanding of certain aspects of the entity and its environment that are relevant to the identification of events and conditions, and supporting application material describes how this will assist the auditor in obtaining information that is relevant in

[3] ISA (UK) 315 (Revised June 2016) *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment* requires the auditor to identify and assess the risks of material misstatement in the financial statements, through understanding the entity and its environment, including the entity's internal control

identifying events or conditions and whether a material uncertainty related to going concern exists.

- ED ISA (UK) 570 Paragraph 10-2(d) requires the auditor to obtain an understanding of the applicable financial reporting framework, to provide the auditor with a basis for discussion with management, and, where applicable, those charged with governance about how management has applied the requirements relevant to going concern.

- ED ISA (UK) Paragraph 10-2(e)–(f) requires the auditor to obtain an understanding of certain aspects of internal control and requires the auditor to understand the method that management uses to make its going concern assessment and factors that may be relevant in obtaining that understanding (e.g. oversight by those charged with governance, or the interaction of management’s going concern assessment with the entity’s risk assessment process). Such an understanding is particularly relevant given the increased complexity of the business environment and technological advancements.

1.5 In circumstances where management has not yet performed an assessment of the entity’s ability to continue as a going concern, the auditor is required to request management to make an assessment.

1.6 Having obtained the understanding required by ED ISA (UK) Paragraph 10-2, the auditor may have identified events or conditions that management failed to identify. In such circumstances ED ISA (UK) Paragraph 11-1 requires the auditor to:

- Request that management perform additional procedures to understand the effect of the events or conditions on management's going concern assessment;

- Inquire as to why management's going concern assessment failed to identify or disclose the events or conditions; and

- Perform additional audit procedures relating to the newly identified events or conditions in accordance with ED ISA (UK) Paragraphs 12-1–12-2

## Obtaining sufficient appropriate audit evidence

1.7 Evaluating management's assessment of the entity's ability to continue as a going concern is a key part of the auditor's consideration of going concern.

1.8 We believe that it is in the public interest for the auditor's work effort in relation to the evaluation of management’s assessment to be enhanced. In particular, the auditor's evaluation of management's assessment should draw on a wider range of available information to support their work (through enhanced risk assessment procedures and related activities described earlier), with a more robust evaluation of management's assessment, including a more rigorous challenge of the method, information and assumptions used by management in making their going concern assessment. In particular, applying the understanding obtained by the auditor through performing risk assessment procedures and related activities in accordance with ED ISA (UK) 570:

- ED ISA (UK) 570 Paragraph 12-2(a) requires the auditor to evaluate management’s method to assess the entity’s ability to continue as a going concern, including determining if the method selected is appropriate in the context of the applicable financial reporting framework and the auditor’s understanding of the entity. The auditor is also required to evaluate whether changes from the method used in prior periods are appropriate.

- ED ISA (UK) 570 Paragraph 12-2(c) requires the auditor to evaluate 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. The requirement also draws links to other audit work, as the auditor is required to evaluate whether the assumptions are consistent with those used in other areas of the entity's business activities. The application material explains that such matters may include, for example, business prospects, assumptions in strategy documents and assumptions used in the making of accounting estimates.

- ED ISA (UK) 570 Paragraph 12-2(b) requires the auditor to evaluate the relevance and reliability of the underlying data used to make the assessment.

## Professional scepticism and management bias

1.9 We recognise the central role that professional scepticism plays in delivering a high-quality audit and have included additional requirements and application material designed to enhance the auditor's application of professional scepticism and consideration of the potential for management bias. In particular:

- More robust risk assessment requirements that provide a better basis for identifying events and conditions and assessing whether a material uncertainty exists related to them. (ED ISA (UK) 570 Paragraphs 10-2 and 12-2)

- A requirement to evaluate whether the existence of events or conditions may give rise to risk of management bias in the preparation of the financial statements. (ED ISA (UK) 570 Paragraph 10-5)

- A requirement to evaluate whether judgments and decisions made by management in making its assessment, even if they are individually reasonable, are indicators of possible management bias (ED ISA (UK) 570 Paragraph 18-1(a))

- A requirement to "stand back" and consider all audit evidence obtained, whether corroborative or contradictory, when evaluating going concern. (ED ISA (UK) 570 Paragraph 18-1(b))

- A definition of "management bias" has been included in the revised standard. (ED ISA (UK) 570 Paragraph 9-1(a))

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

1.10 The Viability Statement included in the Annual Report has the potential to be of immense value to users of the Annual Report, but only if the information it contains is relevant and reliable. Our recent Audit Quality Thematic Review on Other Information[4] in the Annual Report highlighted that audit firms need to increase their focus on viability statements, noting in particular, that audit firms need to improve the application of professional scepticism and pay more attention to the completeness of the information, particularly the linkage of the Viability Statement with the principal risk disclosures.

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[4] Audit Quality Thematic Review: Other Information in the Annual Report (December 2018).

1.11 Consequently, ED ISA (UK) 570 Paragraphs 16-1 and 24-1–24-2 have been enhanced to more closely align with the requirements in ISA (UK) 720 (Revised June 2016) and the auditor is now required to perform 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 that obtained during the auditor's work on going concern.

## Evaluating the appropriateness of disclosures

1.12 The terms "appropriate", "reasonable" and "adequate" are used throughout the ISAs (UK) in relation to disclosures. However, the description of "material uncertainty" refers to "appropriate disclosure of the nature and implications of the uncertainty necessary for…the fair presentation of the financial statements". Accordingly, we propose to align the requirements and application material in ISA (UK) 570 to the use of the term "appropriate".

### Definitions

1.13 The description of material uncertainty has been removed from the requirements and included in the Definitions section of the standard (see ED ISA (UK) 570 Paragraph 9-1(b)).

## Enhancing auditor reporting

1.14 Since the revision of ISA (UK) 570 in June 2016, auditors have been required to report on going concern in every auditor's report for all audited entities.[5] Investors have welcomed the introduction of Key Audit Matters in relation to going concern for public interest and listed entities but have called for more information to be reported.

1.15 In response, where the going concern basis of accounting is appropriate, we have added a new requirement for the auditor’s report to include: (see ED ISA (UK) 570 Paragraph 21-1)

- An explanation of how the auditor evaluated management's assessment of the entity's ability to continue as a going concern and where relevant, key observations arising with respect to that evaluation;
- A conclusion that management's use of the going concern basis of accounting is appropriate; and
- Where no material uncertainty has been identified, a statement that the auditor has not identified a material uncertainty related to going concern.

1.16 Where the going concern basis of accounting is appropriate but a material uncertainty exists, the auditor continues to be required to include a separate section in the auditor's report under the heading "Material Uncertainty Related to Going Concern".

## Strengthening communication with those charged with governance

1.17 To strengthen the dialogue between the auditor and those charged with governance, we have included a new requirement to place more emphasis on communications with those charged with governance in situations where management is unwilling to make or

[5] Unless the going concern basis of preparation has not been used in the preparation of the financial statements.

extend its assessment when requested to do so by the auditor (see ED ISA (UK) 570 Paragraph 15-1).

## Communicating with regulators

1.18 Notwithstanding the requirement in ISA (UK) 250 (Revised June 2016) *Section B—The Auditor's Statutory Right and Duty to Report to Regulators of Public Interest Entities and Regulators of Other Entities in the Financial Sector*, we have included a new requirement for the auditor to consider whether there are any requirements beyond the ISAs (UK) which would require the auditor to report to a regulator (or other supervisory body) when the auditor has determined it necessary to include either a "Material Uncertainty Related to Going Concern" paragraph in the auditor's report or to issue a qualified, adverse or disclaimer of opinion in respect of going concern (see ED ISA (UK) 570 Paragraph 25-1). This better aligns with legal and regulatory requirements for the auditor to report on such matters.

## Scalability

1.19 In proposing revisions to ISA (UK) 570, we recognise that the auditor's ability to serve the public interest includes the ability to apply the standard to the audits of financial statements for all entities. Consequently, specific paragraphs in the application material demonstrate how ISA (UK) 570 is scalable (ED ISA (UK) 570 Paragraphs A3-4, A3-8, A4-1–A4-2, A11-4, A12).

## Withdrawal of existing guidance

1.20 The revised standard is designed to replace the existing guidance and the following Bulletins:

- Bulletin 2008/1 *Audit issues when financial market conditions are difficult and credit facilities may be restricted* (January 2008)
- Bulletin 2008/10 *Going concern issues during the current economic conditions* (December 2008)

1.21 Consequently, the FRC will withdraw these two Bulletins when the revised standard is issued.

## Request for Comments

Comments are invited in writing on all aspects of the Exposure Draft of ISA (UK) 570. In particular, comments are sought in relation to questions 1–10 below:

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 going concern? If you do not consider this to be the case, please set out why?

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

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

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?

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?

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?

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?

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?

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

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?

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

Responses should be sent to **AAT@frc.org.uk** and marked for the attention of **Kate Dalby**.
Responses should be received by **5pm on Friday 14 June 2019**.

## Impact Assessment

The FRC is a principles-based regulator and is committed to issuing proportionate Standards and Guidance that support the provision of high-quality, independent audit. The requirements proposed in this Exposure Draft have been developed in response to particular issues and concerns in respect of going concern in an audit of financial statements.

In making these revisions we have had regard to the FRC's 'Principles for the development of Codes, Standards and Guidance which include:

- there is a clearly defined issue relevant to the FRC's mission and responsibilities;
- the change is the most appropriate way to address the issue;
- one or more of the following conditions is met:
  - a change is necessary to comply or align with a legal requirement; or
  - a change is required in the light of developments in international standards or in UK or European regulation; or
  - the risks to the public interest of not acting are significant, for example, a risk of systemic and/or market failure; or
  - it is possible to eliminate or significantly simplify a current requirement; or
  - it is necessary to clarify a current requirement; or
  - it is possible to create significant additional benefits in the public interest; or
  - a change is necessary to underpin the effectiveness of the FRC's enforcement and disciplinary activities;
- the anticipated benefits of the change outweigh the costs.

With reference to these Principles, the FRC concluded that these revisions are necessary as the risks to the public interest of not acting are significant. In these circumstances, and given the risk posed to investors and other stakeholders by audit failure in this area, the FRC has concluded that it is appropriate to require additional work effort to be applied.

The revised standard has been designed to be scalable, with costs falling mainly on the public interest entities (PIE) audit sector. We believe that benefits in the public interest of enhancements to the quality of audit of going concern, although not quantifiable, will outweigh the costs of changes that may be necessary to audit firms' methodologies, however, it is not possible to quantify a monetary value for those benefits arising.

The cost as a result of these proposals is estimated to be as set out in the following table. However, the FRC welcomes views from stakeholders if they believe that we should consider other factors.

| Revised requirement | Assumptions | Net cost (£m) |
|---|---|---|
| **Familiarisation and Training** (part of firm annual update process so impact is mitigated as they would have done it in any case);<br><br>***<u>These costs are one-off, non-recurring costs.</u>*** | • Updating guidance by technical managers/partners (90%/10%) 300 hours for large firms (6), 25 hours in medium firms (30) and 5 hours in small firms (64), using BIS assumptions for PIEs familiarisation discounted by 50% as these are revisions to existing requirements.<br>• Familiarisation of changes – 0.5 hour per practitioner. Numbers of practitioners drawn from FRC's Key Facts and Trends 2018, assumption that 75% of the holders of the AQ are actively in practice. | 0.505<br><br>2.016 |
| **Increased work effort** in the following areas:<br>• Risk assessment procedures and related activities<br>• Evaluation of management's assessment<br>• Enhanced professional skepticism requirements<br>• Work on Viability Statements<br>• Evaluation of sufficiency and appropriateness of audit evidence<br>• Considering the appropriateness of disclosures<br><br>***<u>These are recurring costs.</u>*** | • Using 97,000 statutory engagements as baseline with aggregate uplift for hours of 0.4% for PIEs/ Other listed and 0.25% for other statutory per ARD allocation. | 10.400<br><br>3.675 |
| **Increased reporting, communication and transparency** in the following areas:<br>• Enhanced reporting for PIEs, listed entities and other entities that apply the UK Corporate Governance Code<br>• Communications with regulators<br><br>***<u>These are recurring costs.</u>*** | • Based on 2,000 PIEs and 800 other listed entities additional requirement 1.5 hours of effort at manager rate average of £400.<br>• For other statutory audit, based on a nominal increase at principal rates.<br>• Reporting to regulators based on 5.0% requirement at 2 hours per report. | 1.313<br><br>1.090<br><br>0.100 |
| **Total estimated costs:**<br>Of which one-off:<br>Of which recurring: | | **19.099**<br>2.521<br>16.578 |

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