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Dear Ms Dalby

### **ISA (UK) 570 (Revised) consultation**

We welcome the opportunity to comment on the exposure draft of amendments to ISA (UK) 570 (Revised) Going Concern ("the ED"). It comes at the same time as the Call for Views by the Independent Review into the Quality and Effectiveness of Audit conducted by Sir Donald Brydon ("the Brydon Review") to which we have recently responded. We note in that response that there is scope for increased corporate reporting of, and audit assurance over, ultimate business resilience. If taken up, that would be for a new auditing standard, with ISA (UK) 570 remaining as addressing the going concern basis of financial statements. Other than our comments on business resilience in the final section of this letter, we therefore respond to this consultation solely in the context of the going concern basis of accounting.

#### ***The ISA (UK) as only one part of the issue***

As part of an audit profession working collectively to deliver audit quality, we welcome an update of this auditing standard, including because the audit of the directors' use of the going concern basis of accounting ("the going concern basis") is a key element of the public's interest in auditing.

As the consultation notes, however, revised procedures for auditors are but one element of a wider programme. We believe that a wider programme, not all of which will be under the FRC's (or the proposed new Audit, Reporting and Governance Authority's) direct control, should ultimately include:

- improved requirements for directors of companies in respect of going concern assessment and disclosure;

- an ISA from the IAASB that not only incorporates the additional procedures envisaged in the ED but is also written to facilitate consistent high quality application through ease of use; and
- assisting public understanding by being clearer as to the limitations of the going concern basis of accounting in relation to the longer term sustainability of a business.

We agree that revising the auditing standard should not wait on those other constraints. Change now should nevertheless, we believe, include some movement on these, and we comment on these below. Further, it would be beneficial to acknowledge these constraints in the revised standard and/ or any material or statements that the FRC publishes alongside it.

*Requirements for companies – disclosures, assessments and controls*

Much of what would be required by the ED would require many companies to improve their understanding of going concern and their processes for assessing it. For example:

- If a longer look-forward period were required (and see our answer to question 4), and if disclosure of material uncertainties needs to be improved, then such requirements must first fall directly on the companies.
- If auditors are to assess companies' controls over the going concern assessment then first those controls must exist, i.e. be appropriately designed, implemented and operated, and a suitable framework would be required against which the controls could be assessed (for example a UK SOX equivalent – see below). The operating effectiveness of such controls (over business forecasting, for example) is rarely assessed at present as they are usually less formal and less precise than those over the accounting itself. Further, it is not made clear whether these are controls beyond the financial statements, extending to the business/ financing itself (which would be a significant change in the purpose of audit).

As noted in our response to the Brydon Review, the going concern requirements are more prescriptive for auditors than for directors. Yet in practice, it is the directors who are responsible for maintaining a resilient business model. The current expectation gap is in part a consequence of this asymmetry. Consequently, it would be unhelpful for the above matters to be addressed only indirectly to companies through an auditing standard; that is an approach that, even before these changes, requires auditors too often to invest considerable time in requesting management to provide sufficient analysis and relevant documentation to support that assessment. The current framework relies on the auditor to persuade the company that a matter needs to be addressed but, without stronger requirements for companies, this can be challenging. Therefore we strongly recommend that the FRC publishes equivalent guidance for directors alongside proposed changes to the standard.



Such guidance would be a welcome short-term aid. Ultimately, however, we consider that the framework in respect of going concern for companies needs review and change in order to achieve greater consistency of assessment and clarity of disclosure. IAS 1 (e.g. for listed companies) does not define a material uncertainty itself; uses an inadequate look-forward period (running from balance sheet not approval date, such that the minimum period could often be too short); and is not clear that the words “*material uncertainty that ...*” must be disclosed.

The UK approach hitherto has been to top this up through a comply-or-explain requirement in the Corporate Governance Code and associated non-mandatory guidance, and also through some non-mandatory guidance for unlisted companies. We recommend that the FRC considers whether this work-around remains fit for purpose. We recognise, however, that the FRC, although a leading thinker on, and influencer of, global standards, cannot amend IAS 1 or otherwise supplement it without raising questions of actual or *de facto* national amendments to IFRS – fracturing what should be a globally consistent standard. Thus, until the IASB revises the global standard in a clear, effective and prompt manner, a more immediate solution might arise from a recommendation of the Independent Review of the FRC (the FRC Review).

The FRC Review recommended consideration of, and consultation on, a strengthened framework for internal controls on a similar basis to the Sarbanes-Oxley (SOX) approach to internal financial controls, and this is something that we support. The inclusion of a specific requirement for the auditor to consider controls in respect of the going concern basis would fit with that. The lesson from the US experience in adopting SOX was that it was important to provide requirements and guidance for companies as well as auditors. We therefore believe it critical for the FRC to address this in relation to controls over going concern, from the assessment through to actual disclosures. This could provide an avenue to articulate standards to which companies must adhere and so a formal framework against which auditors can assess the extent and nature of compliance. This would improve culture and outcomes at companies and would facilitate an environment that supports good quality audits.

#### *Ease of use – clear and concise*

We recognise the desirability of closely following the IAASB’s ISAs. Naturally, this needs to be balanced with the objective of having UK standards that are robust enough both in their requirements and also their ease of use and hence consistency of application. Thus the ED rightly goes significantly beyond the IAASB’s requirements. Subject to that, however, the ED still largely re-arranges the IAASB’s text and so retains IAASB’s lack of clarity.

Ultimately a fully rewritten standard from the IAASB is needed. In the meantime we would support the FRC’s (or ARGA’s) taking the opportunity to play a leading role in pursuing a better global standard by writing a clear and concise ISA (UK) 570 afresh.



There is also a question of whether such a UK re-write should occur in two steps – something close to this ED brought onto force and then a further change to a re-write within a relatively short space of time, or in one step. The latter would be the ideal.

As to the issues with the current IAASB text, a particular concern is the lack of a clear definition of a “material uncertainty”. This is critical as the main thrust of the ED is to identify whether or not a material uncertainty exists and if so whether or not it has been appropriately disclosed. The ED refers to a material uncertainty as being events or conditions that warrant disclosure, but this circular definition does not answer the question of what events or conditions warrant such disclosure. This also implies that events or conditions that are not material uncertainties do not need to be disclosed; yet elsewhere such disclosure is encouraged. Furthermore, a material uncertainty is also described as a potential consequence of events and conditions that may cast significant doubt over the use of the going concern basis, but in the required audit report and financial statement wording, significant doubt is the consequence of a material uncertainty. In Appendix 1 we make some suggestions for alternative definitions.

The current IAASB-based standard might also be read as implying that a material uncertainty could be avoided by the possibility of mitigating actions. However, it is important to identify the extent to which those actions are within the control of management – a point that is not present in the standard. For example, it would be unusual to accept a case of no material uncertainty if a company needs to make a disposal of an illiquid asset by a particular time and for a particular cash sum in order to stay within its facilities, covenants etc. It may be that the text needs to distinguish between, and set different thresholds for, mitigations of what would otherwise require the break-up basis and what would otherwise amount to a material uncertainty.

We have collated a list of specific drafting comments, which we would be happy to share separately, to further assist in identifying the extent to which the standard would benefit from change.

#### *Public interest*

The proposed revisions are set out in the context of the public interest. There is a wider question though as to the particular role of public interest in the work of the auditor, which is subject to separate consultation in the Brydon Review, and which will have future relevance to the assessment of how the audit should address going concern.

A key consideration of the Brydon review is an examination of who audit (and by extension corporate reporting) is for. The varying views over what “going concern” means are a particular example of this. As a matter of preparation and auditing of financial statements for shareholders, going concern is about the appropriateness of the going concern basis of accounting rather than the break-up basis of accounting, together with disclosure of any material uncertainties over the use of that going concern basis



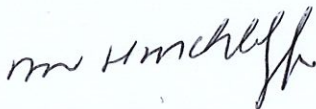
(which requires only a realistic chance of survival). If corporate reporting and auditing were aimed at the public directly – rather than their benefiting as a by-product of reporting and auditing aimed at shareholders – then going concern would more likely be a question of the continuity or ultimate resilience of the entity for its own sake rather than for its possible effect on the balance sheet numbers reported to shareholders (assurance over the entity not over its financial statements). In that context expectations of directors and of auditors could be quite different. In our response to the Brydon Review, we noted there may be scope for corporate reporting and auditing to move beyond the going concern basis of accounting to focus on business resilience: considering the factors that would cause the business to fail and stress testing those critical assumptions which leave the business model most vulnerable. To that end, ARGA should seek to develop a framework for resilience measures - to be identified and reported on by the company but assured through the audit - building on relevant experience such as the stress tests conducted by the banking sector, and moving towards the 'clean bill of health' which users most desire.

\* \* \*

We set out in Appendix 1 to this letter our suggestions relating to the terms “material uncertainty” and “significant doubt”, and in Appendix 2 our responses to the specific questions raised in the consultation.

We support the FRC’s revision of ISA (UK) 570 but appreciate that this response addresses wider matters than the present ED and may be ambitious in its wider recommendations. So please do contact me, Jimmy Daboo (on 020 7311 8350) or Mike Metcalf (on 020 7694 8081) if you would like to discuss this further.

Yours sincerely



Michelle Hinchliffe  
UK Chair of Audit

## Appendix 1 – Defining a material uncertainty

### *Terminology*

In our view it would be more straightforward if the ISA were structured as:

- “risk factors” (e.g., the matters in paragraph A3) that require follow-up procedures to
- determine whether one should conclude and report that there is a “material uncertainty that casts significant doubt on the entity’s ability to continue as a going concern.” Please note that we have used “that cast” here, rather than the inconclusive “may cast”.

Thus significant doubt etc. would be part of (the consequence of) a material uncertainty. What is currently called “significant doubt etc.” in most places in the IAASB text would become referred to as risk factors.

### *Meaning*

We suggest that “material uncertainty that casts significant doubt on the entity’s ability to continue as a going concern,” might be defined as either:

- events or conditions that present more than a remote possibility that they will develop in such a way that the entity will have no realistic alternative but to liquidate or cease trading; or
- events or conditions for which the worst reasonably possible development would result in the entity having no realistic alternative but to liquidate or cease trading.

These suggestions incorporate the test for the change from the going concern basis of accounting to the break-up basis of accounting. That is because the issue is uncertainty over the applicability of the going concern basis of accounting. No doubt these suggestions could be refined and other suggestions along similar lines be drafted; and they may need to reflect a look-forward period. However, we trust that these suggestions are helpful.



## Appendix 2 – Consultation questions

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.

Overall, we do not consider that the proposed revisions will result in more consistent application of the standard across all audits. As noted in the main text of our letter the text of the standard, being based on the IAASB text, would benefit from being drafted more clearly and concisely.

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

As discussed in the main text of our letter, the role of public interest in audit needs to be considered in the light of the ongoing wider debate in this area.

As regards whether the proposed revisions to the standard to address the perceived expectation gap, the introduction of additional auditor disclosure may be helpful (provided it is proportionate – see question 7), but we are concerned that a positive statement on going concern by the auditor *alone* could have the opposite effect and increase the expectation gap.

In order to address the expectation gap, we recommend that improvements in the auditing standard be accompanied by corresponding improvements and clarity in the requirements applicable to preparers of financial statements, together with efforts to educate users of the financial statements on the meaning of the going concern basis and the different roles of directors and auditors.

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.

As discussed in the main text of our letter, we are concerned that these proposals alone will not lead to a major improvement in company reporting or auditing. (We recommend also improved requirements for companies and a clearer and more concise text ultimately from the IAASB.) The level of audit evidence obtained over management's assessment is in practice likely, at least in the meantime, to be the same as under the extant standard.



In respect of the longer-term viability statement, the ED proposes additional audit procedures for UK Corporate Governance Code adopters. Whilst we welcome further clarification of the work that is expected to be performed in this area, we are concerned about the particular question of whether management has chosen an appropriate assessment period. Management is required under the Code only to choose a period and explain why they have chosen it. There is no requirement for management's period to be "appropriate" according to particular criteria against which the auditor could base their 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?

If a longer minimum period is called for, it should apply to the company as well as to the auditor.

As to whether the minimum period for both should increase, the current assessment requires consideration of all relevant information ("all relevant information about the future" in the existing standard) and must cover a period of at least twelve months from the date of approval of the financial statements. We believe there is a common misconception that a twelve month period will always be adequate. At the least, the auditing standard (and supporting changes for companies) should reinforce clearly that the current twelve month requirement is a minimum, and that events and conditions that are forecast to (potentially) occur beyond that timescale should not be ignored. This will mitigate the risk of the stated period being mistaken for a hard cut-off.

However, the specified minimum period itself should not be so long as to risk exceeding the period for which developments of events and conditions can be reasonably foreseen – relevant information about the future – for which the minimum is merely a backstop. We believe that any major extension beyond a 12-month backstop would risk that. Once beyond a reasonably foreseeable period, there is inevitably increased uncertainty (a point made by the ED at paragraph A6-1) and the more likely it is that material uncertainties will therefore exist. More instances of apparent material uncertainties could be undesirable, as it would weaken the signal given by such disclosure.

Further, the ED suggests that the going concern and longer-term viability statement assessment period might be the same. We do not consider that it would be appropriate to extend the period of going concern assessment to be the same as the period covered by the viability statement for the reason given above. In addition, it would remove any distinction between the two statements and thereby reduce information: the going concern assessment covers current circumstances, whereas the viability statement covers potential future circumstances (scenario planning, e.g. what if the perfect storm arose) that may arise over a necessarily longer timescale (even though it is difficult to articulate the likelihood). Moreover, as discussed in our response to the Brydon Review,



the viability statement needs to broaden into a statement on business model resilience, e.g. similar to the stress tests conducted by the banking sector.

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?

We consider that the standard could be clearer in this respect.

Paragraph 12-1 separates the requirements to (a) obtain evidence about the existence of "events or conditions that may cast significant doubt" and (b) the requirement to consider whether a material uncertainty exists. Paragraph 12-2(d) refers to determining whether there are mitigating actions that management could take, yet it is unclear if this is relevant in considering whether:

- there is an "event or condition" at all; or
- it is relevant only when considering whether there is a material uncertainty.

Paragraph A8-9 refers to the significance of events or conditions potentially being mitigated by management's plans for future actions which implies the former, although the examples cited may often be relevant in assessing whether a material uncertainty exists. As noted in the main text of our letter, we do not consider that mitigating actions outside the control of management could in themselves necessarily eliminate a material uncertainty. Further, the need to have visibility over (and consider) the worst reasonably possible downside case separately from the mitigants is one of the areas where auditors often have to make extensive challenges to management. Indeed, for some it comes as a surprise that the auditor wants to consider the worst reasonably possible downside at all rather than just management's view of the most likely outcome. Please see our comments in the main text of our letter concerning the need for standards/ requirements for management.

This is also linked to our concerns over the definition of a material uncertainty in the standard. "Events and conditions that may cast significant doubt" are considered in the ED (and the extant standard) to exist separately from material uncertainties. However, the definition of a material uncertainty itself, and the words required to describe it in the financial statements, includes within it events and conditions that may cast significant doubt.



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?

Whilst management bias should be considered and auditor's professional scepticism applied in all areas of an audit under ISAs (UK), we agree that these concepts may be more relevant in the audit of going concern. However, we consider that the revised standard could more specifically explain how these concepts apply within the context of going concern (avoiding using language that might imply that they are not relevant in the audit of other areas). For example, we would be open to the standard including both a presumption that there is management bias in going concern assessment and clarity on what is expected of auditors in response.

However, we do not agree that an inadequate going concern assessment process necessarily indicates wider management bias.

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?

Whilst we welcome the proposal to require more specific disclosures in respect of the use of the going concern basis in the auditor's report, we have some reservations over these proposals.

The positive assurance statements in respect of going concern may have the unintended consequence of widening the "expectation gap", since, first, there is a greater risk of such a statement being viewed as a guarantee of no-business-failure. Second, as this auditor's statement would stand in contrast to the absence of such a statement from the directors, it would reinforce misconceptions about respective responsibilities.

In respect of the proposal to disclose details of the audit work performed in respect of going concern, it amounts to a *de facto* key audit matter (KAM), because the risks and procedures are to be described; and this would be applicable to all companies by default. We do not consider this to be proportionate for all audits, because it does not distinguish cases based on their specific circumstances. E.g., the approach proposed in the ED runs the risk of reduced visibility of those circumstances where going concern is a true KAM. It also introduces a *de facto* KAM into non-long-form reports.

The proposed requirement to present "key observations, where relevant" in all audit reports is included with no guidance as to what these are considered to be. Given the proposed requirement to report a (binary) conclusion on going concern and material uncertainties, it is not clear what "key observations" might otherwise be (for other KAMs they are binary conclusions according to the FRC's Audit Technical Advisory Group rolling record of actions). Is it intended to mandate "graduated findings" on going



concern? Whilst we would welcome this where going concern is a KAM, it is a matter for wider consultation and the eventual decision needs to be clearly stated in the revised standard. As noted above, the scope of such a requirement also needs to be proportionate.

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?

We are concerned that the requirements of the ED may not be wholly scalable to all entities. The guidance on scalability appears to be drawn from the extant standard; we could not locate any specific scaling of the requirement to consider controls in smaller entities.

The reporting requirements also appear disproportionate for smaller entities, and may also be difficult to apply for certain types of entity. For example, pension schemes, charities, and some public sector entities potentially have different factors to consider when assessing going concern, such that the standard procedures and reporting requirements of the ED may be difficult to apply in practice.

Specific guidance on how the proposed requirements should be applied in the above scenarios would be welcome.

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

Yes, subject to the FRC's consideration of the length of time entities would need to implement formal controls over their going concern assessment process.

In addition, the ED could be clearer, if the revised standard is adopted early, as to whether the reporting elements of the revised standard would supersede those of the extant standard.

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?

Bulletins 2008/1 and 2008/10 were issued before the issue of the currently applicable set of ISAs (UK). It is therefore appropriate that they be either updated or withdrawn and superseded, and it is logical to include content that remains relevant directly in the revised version of ISA (UK) 570 to the extent that it relates to going concern.

However, we were unable to locate all of the relevant guidance from the Bulletins in the ED. We suggest that a thorough review of the Bulletin guidance is performed and relevant elements incorporated into the final version of ISA (UK) 570 (revised).



We further note that the Bulletins include content other than in respect of going concern. The FRC will need to consider whether it is necessary to retain that guidance in another form if the Bulletins are withdrawn.

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

We strongly recommend that the requirements in place for directors be improved. Ideally IAS 1 would be changed but a medium term solution may be afforded through the FRC Review's recommendation to consider implementing an internal control framework on a similar basis to SOX. In the short term at least some additional guidance for companies is required alongside this revision to ISA (UK) 570.