# GOING CONCERN: RECOMMENDATIONS TO STRENGTHEN THE FINANCIAL REPORTING ECOSYSTEM

VIEWS.
& IDEAS.

AUDIT & ASSURANCE
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## HIGHLIGHTS

When a company collapses, all stakeholders are affected, from employees to investors, and it eventually erodes the public's trust in financial markets.

This publication, with its counterpart on fraud, presents recommendations to strengthen the financial reporting ecosystem. This is especially topical after recent corporate failures, fraud cases and companies getting under pressure due to the ongoing COVID-19 pandemic. We thus re-examine the role of key parties to make the system more resilient: those within the company, external auditors, standard setters, legislators and public oversight authorities.

The system should become better at dealing with and communicating on issues with a company's ability to continue as a 'going concern'. Simply put, if it will remain in business for the next 12 months.

With this aim, we propose the following recommendations:

- broaden companies' work effort
- mandate disclosure on companies' risk management systems on going concern and expand the auditor's involvement
- mandate going concern disclosure even if no uncertainties
- change in mindset, transparency and communication
- mandate an audit committee in each public interest entity
- clarify and harmonise the period for going concern assessment
- broaden auditors' area of consideration and work effort
- make early warning mechanisms for auditors effective

We also invite relevant parties to explore whether and, if so, how assessing companies' longer-term viability and resilience, and interconnecting of financial and non-financial information could contribute to this aim.

We call for a joint effort of key parties to strengthen the ecosystem. To this end, we ask you to send your thoughts and opinions on our recommendations to julia@accountancyeurope.eu by 30 April 2021.

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# INTRODUCTION

Recent corporate failures as well as the impact of the ongoing COVID-19 pandemic indicate the need to reconsider the functioning of today's financial reporting ecosystem. The system should evolve and become better at identifying issues with a company's ability to continue as a 'going concern' (i.e. continue in business; see page 3 for more detail) and be equipped with mechanisms for dealing with them. This will help to promote the public's trust and confidence in the information reported by companies and ultimately improve the functioning of the economy.

## OBJECTIVE

This publication aims to help develop the future role of the following key parties in the financial reporting ecosystem in relation to a company's ability to continue as a going concern:

- a company's board(s), audit committee and management
- external auditors
- accounting/financial reporting and auditing standard setters and legislators
- public oversight authorities of companies and auditors

We explore their roles and responsibilities, before proposing how these could be further developed. While acknowledging that the primary responsibility lies with companies, we believe that each party, and the interactions amongst them, need to evolve to create a stronger ecosystem. One that will be better able to deal with the changing environment and challenges ahead. Strengthening the ecosystem will likely require additional effort and investment of the parties involved which will translate into higher costs. These costs have to be weighed up against potential benefits.

This publication proposes 10 recommendations starting on page 8 with regard to the roles of all key parties in the financial reporting ecosystem. The role and accountability of companies' boards and management needs to be clarified and strengthened. This needs to go hand in hand with strengthening the role and accountability by the auditors, standard setters, legislators and public oversight authorities. Transparency and accountability are key to maintain trust and confidence in the economy.

No amount of improvement can prevent all corporate failures as companies taking risk, within boundaries, is part of our free-market economy. We also cannot eliminate unexpected events such as the current pandemic. However, a stronger financial reporting ecosystem could enable entities to timely adopt preventative measures or to reduce or better manage the implications of these failures.

## SCOPE

This publication refers to the requirements in the:

- European Union (EU) legislation on accounting and financial reporting[1]
- EU legislation on auditing[2]
- International Financial Reporting Standards (IFRS) including the International Accounting Standards (IAS)[3]
- International Standards on Auditing (ISA)[4]

These laws and standards may be implemented differently at national level. Countries' different starting points should be considered in this publication's context and when deciding on any changes to the ecosystem. Some European countries may be considering changes such as our recommendations, or already have them in place.

Our recommendations focus on European public interest entities (PIEs)[5], and their financial reporting and audit requirements. Some recommendations may also be relevant for non-PIEs and their auditors. Their applicability depends also on a country's and/or a particular company's governance model.

Our recommendations are based on discussions with Accountancy Europe's reporting and audit experts and stakeholders including accountants, audit committee members, investor representatives, standard setters and regulators.

## IAASB'S CURRENT WORK ON GOING CONCERN

The International Auditing and Assurance Standards Board (IAASB) has also identified the need to revisit the area of going concern. Its recent Discussion Paper[6] notes that regarding going concern and fraud, there is an expectation gap between the reality of financial statements audits and what the public expects from auditors. The IAASB aims to identify the challenges, issues and appropriate responses to these. This will serve to understand whether, and if so, how auditing standards can meaningfully narrow the gap.

## EXPLAINING THE GOING CONCERN CONCEPT

'Going concern' is an economic and accounting term used to describe a company which is assumed to be financially stable enough to continue to operate for the foreseeable future. 'Foreseeable future' is usually regarded as being at least 12 months from the company's year-end date or the date the financial statements are approved.

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[1] The Directive 2013/34/EU on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings; available at https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32013L0034

[2] The Directive 2014/56/EU contains requirements governing all statutory audits in the EU, it is available at https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32014L0056 and the Regulation (EU) No 537/2014 contains additional requirements that relate specifically to statutory audits of PIEs. The Regulation is available at https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32014R0537

[3] The IFRS and IAS standards are available at https://www.ifrs.org/issued-standards/list-of-standards/. Note that *IAS 1, Presentation of Financial Statements* deals with a company's responsibilities in relation to going concern in paragraphs 25 and 26

[4] The ISA standards, issued by the International Auditing and Assurance Standards Board, are available at https://www.iaasb.org/publications/2018-handbook-international-quality-control-auditing-review-other-assurance-and-related-services-26. Note that the provisions in *ISA 570 (Revised), Going Concern* deal with the auditor's responsibilities in relation to management's use of the going concern basis of accounting in the preparation of the financial statements

[5] Based on EU legislation, PIEs are all listed entities, banks, insurance companies and entities designated as such by member states. For more details, please refer to our publication *Definition of Public Interest Entities in Europe* (March 2019); available at https://www.accountancyeurope.eu/publications/definition-public-interest-entities-europe/

[6] The Discussion Paper was open for comment until 1 February 2021. Accountancy Europe has submitted its response which is available at https://www.accountancyeurope.eu/consultation-response/comment-letter-to-iaasbs-discussion-paper-on-fraud-and-going-concern/

Going concern is a fundamental assumption for preparing a company's financial statements. However, companies are not required, under the international standards or EU legislation, to explicitly disclose in their financial statements the basis for this assumption.

The going concern concept has two important functions:

- **prevention**: it helps companies identify, realise and address any going concern risks and issues
- **transparency or disclosure**: it provides useful information on a company's going concern matters to its investors and other stakeholders. It influences their economic decision-making as it aims to provide them with confidence for entering into a business relationship with the company which is key for the smooth functioning of the economy

There is a high bar to depart from preparing financial statements on a going concern basis. They are prepared as such, unless management either intends to liquidate the company, cease its operations, or has no realistic alternative but to do so. When a company does not prepare financial statements on a going concern basis, it shall disclose that fact, together with the basis on which it prepared the financial statements (i.e. liquidation or breakup value) and the reason why the company is not regarded as a going concern.

The appropriateness of the use of the going concern basis of accounting (or not) is a matter for the auditor to consider in evaluating management's assessment. This is an integral part of each financial statements audit.

Assessing a company's ability to continue as a going concern has its inherent limitations which cannot be eliminated. This is because such assessment is based on the future and forecasts and thus always involves a level of uncertainty. The current pandemic is one recent example of an unforeseen event with far-reaching consequences for many companies.

## LINK BETWEEN GOING CONCERN AND FRAUD

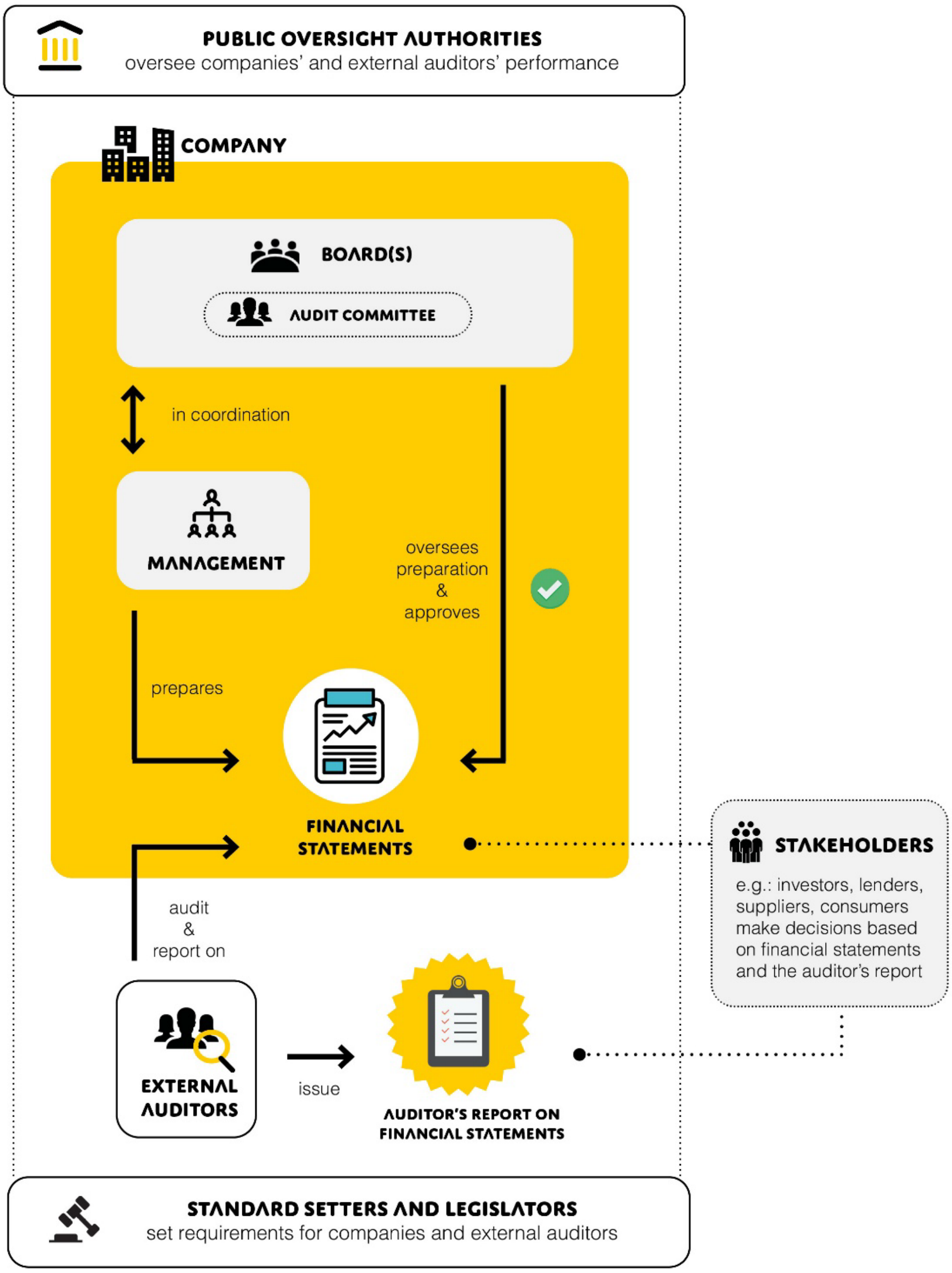
Considering the link between going concern and fraud, we have also worked on and issued the publication *Fraud: Recommendations to strengthen the financial reporting ecosystem* (February 2021).

There is often a link between going concern and fraud in that some fraudulent behaviour seeks to cover up potential going concern issues within a company. Fraud can therefore sometimes delay the discovery of going concern issues. For instance, numerous companies have been negatively impacted by the COVID-19 pandemic and many have had to adapt their respective business models to get through the crisis. Sudden and significant changes in business models and pressure, for example, to meet bank covenants enabling a company to have the necessary financing to avoid bankruptcy, might increase the risk of fraud.

The opposite also holds true – fraud such as misappropriation of assets can cause going concern issues and even lead to bankruptcy. This may happen, for example, when lenders and/or clients lose confidence in a company after a large fraud.

## FINANCIAL REPORTING ECOSYSTEM: CURRENT ROLES AND RESPONSIBILITIES

The visual below illustrates the financial reporting process and the roles of its main parties that together form this ecosystem. Note that there might be differences depending on the national jurisdiction and applicable corporate governance system. Below we further detail each party's role in relation to a company's ability to continue as a going concern, including its assessment.




### COMPANIES ARE PRIMARILY RESPONSIBLE FOR ASSESSING GOING CONCERN

The primary responsibility for the accuracy of a company's financial statements, including the assessment of its ability to continue as a going concern, lies with the company's board and management. A company can have one or more boards, depending on its governance model and/or jurisdiction – in this publication, we use the general term 'board' which can indicate both.

The role of each relevant party within a company depends on the governance structure. All these parties have to work together to ensure the integrity of the financial statements.

### ROLE OF MANAGEMENT

A company's management prepares its financial statements, including the assessment of the company's ability to continue as a going concern. Subsequently, current disclosure requirements are as follows:

- management is required to make disclosures in case of material[7] uncertainties that lead to significant doubts about the company's ability to continue as a going concern
- when management does not identify going concern issues, no disclosure related to going concern is ordinarily required in the financial statements
- neither is a disclosure required when there is initially a material uncertainty, but management puts plans in place to mitigate it, making the uncertainty no longer material[8]

  There is, however, an IFRS interpretation that such management judgement would need to be disclosed if significant. This would be in case of a 'close call' when it is not clear whether management's mitigating plans will be sufficient, but on balance, after much analysis, it is concluded they are just about sufficient[9].

Forecasting how the company will be performing over the next 12 months inherently includes judging future circumstances based on information available at the time the forecast is made. This uncertainty is one of the inherent limitations of assessing going concern. Later developments can lead to different outcomes than what seemed reasonable at the time the judgements and forecasts were made. A company's size and complexity, and the nature of its business, including the degree to which it is influenced by external factors, also affect management's judgements concerning future circumstances.

The current pandemic illustrates such an unforeseen development. Forecasts prepared before the pandemic are highly unlikely to have considered its potential impact. Even once the pandemic was identified, there was so much uncertainty that companies might have underestimated its consequences at the time of making their forecasts.

### ROLE OF BOARD AND AUDIT COMMITTEE

A company's board has specific responsibilities for the financial statements. This includes understanding and approving the assumptions the company adopts such as the one on going concern.

The board also has specific responsibilities where the going concern assumption is in doubt, such as reviewing forecasts and ensuring that adequate financial support is in place should the company need it.

Audit committee members in a PIE are drawn from its non-executive directors or its supervisory board. The audit committee is responsible for overseeing the entire financial reporting process, especially where this requires significant judgements and estimation like the going concern assessment.

The internal audit function is also important in a company's governance structure. It usually reports directly to the audit committee. Its main role is to assess the efficiency and effectiveness of the company's internal controls, including risk management systems on going concern, which help produce reliable financial information.

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[7] Note that in accounting terms, financial statement information is considered 'material' if its misstatement, including an omission, would influence users' economic decisions

[8] As per IAS 1, paragraphs 25 and 26

[9] Based on IFRS Interpretations Committee Decision *Disclosure requirements relating to assessment of going concern (IAS 1 Presentation of Financial Statements)* (July 2014); available at https://cdn.ifrs.org/-/media/feature/supporting-implementation/agenda-decisions/ias-1-disclosure-requirements-relating-to-assessment-of-going-concern-jul-14.pdf

## EXTERNAL AUDITOR'S ROLE

The auditor's responsibilities on going concern, under the current ISAs, are to:

- obtain sufficient appropriate audit evidence, and conclude on the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements
- conclude whether there is a material uncertainty, based on the audit evidence obtained, about the company's ability to continue as a going concern

When the auditor does not identify going concern issues, no disclosure related to going concern is required in the auditor's report. Such an auditor's report is an implicit agreement by the auditor on the appropriateness of the use of the going concern basis for the financial statements' preparation. However, the auditor's report does not aim to guarantee whether a particular company will continue as a going concern. It is based on the information included in the financial statements by management and must be read in conjunction with the financial statements.

In case of going concern issues:

- if the auditor concludes that a material uncertainty about going concern exists and management has adequately disclosed this in the financial statements, the auditor's report should include a separate section 'material uncertainty related to going concern' without modifying the audit opinion
- if management has not disclosed or not properly disclosed the existing material uncertainty, the auditor has to report the identified issues by expressing either a qualified or adverse opinion on the company's financial statements
- if the auditor is unable to obtain sufficient appropriate audit evidence for management's use of the going concern assumption, the auditor has to issue a disclaimer of opinion

The auditor may also decide to include going concern as a Key Audit Matter (KAM) in the auditor's report in certain circumstances. This occurs, for example, when a 'close call' has arisen from events or conditions that may cast significant doubt on a company's ability to continue as a going concern, but ultimately the conclusion is that there is no material uncertainty. By including a KAM on going concern, the auditor highlights that in the audit, going concern was considered as one of the areas of most significance and at higher risk of material misstatement. For example, based on an analysis on financial year 2019 which we carried out, there were 610 companies for which the auditor included a KAM on going concern in the auditor's report. This represents around 17% of the analysed listed companies. See the Appendix for more information on the analysis on KAMs.

In addition to the above, the EU audit legislation requires auditors to report on any information identified during the financial statements audit of a PIE that may relate to a material threat or doubt concerning the continuous functioning of the PIE. Such reporting should be done to a dedicated national supervisory authority of a PIE or, if determined by a member state, to a competent authority for audit oversight.[10]

### ANALYSIS OF AUDITOR REPORTING ON GOING CONCERN IN LIGHT OF THE PANDEMIC

For markets, there is a signalling value in the auditor reporting on issues which impact a company's ability to continue as a going concern – the auditor's work thus contributes to transparency in the economy. This has become even more prominent in the context of the current crisis. Therefore, we decided to take a closer look at auditor reporting on the ability of corporates to continue as going concerns during the pandemic.

In audits related to the financial year 2019, based on the analysed sample, there were 603 European listed companies for which the auditor concluded there was a material uncertainty about their ability to continue as a going concern. This represents 9% of the analysed companies. By examining the

[10] Article 12 of the 2014 EU Audit Regulation; available at https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32014R0537. Note that we understand 'continuous functioning', as used in the Audit Regulation, as a synonym of 'ability to continue as a going concern'

auditor's reports on these companies, we were able to identify that almost half of the companies with a material uncertainty on going concern had difficulties staying in business due to the pandemic's impact. Note that audits related to the financial year 2019 were carried out in the first half of 2020 when the pandemic was already spread all over the world. For further details on the analysis, refer to the Appendix.

The pandemic's impact on the current reporting season on financial year 2020 will likely be greater. In the auditor's reports, we could expect more references to the pandemic linked with uncertainty around going concern.

### ROLE OF STANDARD SETTERS AND LEGISLATORS

Standard setters such as the IASB and IAASB, and EU and national legislators set requirements for:

- companies' assessment and reporting on their ability to continue as a going concern
- auditors' work and reporting on going concern

International standards and EU legislation drive consistency which our interconnected economies need. Therefore, any changes related to going concern requirements should come from international standard setters on accounting and auditing as well as EU legislators. They are the ones that can enact structural changes to the companies and auditors' work on going concern.

### ROLE OF THE PUBLIC OVERSIGHT

National securities market authorities (SMAs) for listed entities are responsible for enforcing the financial reporting rules and increasingly also those related to non-financial information. Their main aim is to protect investors and maintain orderly and efficient markets. SMAs contribute to promoting a market environment that is worthy of the public's trust.

National audit oversight bodies (AOBs) have the ultimate responsibility for overseeing the audit profession. By examining the quality of auditors' work, they are expected to ensure audit quality which warrants the public's confidence in audit.

In addition, a national competent authority supervising a PIE or an AOB can be dedicated as national competent authorities responsible for investigating issues. This can include a material threat or doubt concerning a PIE's ability to continue as a going concern, brought to their attention by auditors.[11]

## 10 RECOMMENDATIONS TO STRENGTHEN THE FINANCIAL REPORTING ECOSYSTEM

In this section, we recommend ways to improve the role of all relevant parties in the ecosystem regarding the going concern matter, and even beyond, in the PIE sector. By suggesting these enhancements, we aim to contribute to the debate which is already taking place at an international level (IAASB Discussion Paper on this topic) and in several European countries like Germany, the Netherlands and the UK. *Our main proposals* represent the view of Accountancy Europe and *Beyond going concern: Ideas to be explored* are areas which would require further debate and consideration especially by legislators. Our recommendations start from the requirements in relevant international standards and EU legislation.

The main proposals complement each other and therefore it is not appropriate to consider any of them in isolation.

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[11] Reference is made to Article 12 of the 2014 EU Audit Regulation; available at https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32014R0537

## OUR MAIN PROPOSALS

### 1. BROADEN COMPANIES' WORK EFFORT

PIEs, which are usually larger companies or those with more complex business models, might need to put more effort into performing their going concern assessment.

Currently, a company's management is required to make a going concern assessment and – in case of a material uncertainty – to make a disclosure in the financial statements. These requirements are covered in just two paragraphs in IAS 1. This seems limited when compared to an entire ISA 570 (Revised) dedicated to requirements on the auditor's work on going concern.

We therefore believe that standards and/or relevant legislation need to broaden companies' work effort on going concern assessment. Companies should be required to implement integrated systems and have adequate procedures to prepare reliable cashflow forecasts using realistic assumptions which are grounded in economic, market, and sector trends and outlook. They should also run scenario analyses, in line with the size and complexity of their business and market. This serves to stress test and reverse stress test the validity of their going concern analysis, and to identify the liquidity headroom and implications for covenant compliance.

Management should have the necessary education, competences and skills to prepare such forecasts and analyses, or take appropriate training or supplement their skills with external expertise where needed.

Boards and especially audit committees oversee management's work. Therefore, they should also have the necessary experience and skills to be able to detect any (potential) problems and challenge management.

### 2. MANDATE DISCLOSURE ON COMPANIES' RISK MANAGEMENT SYSTEMS ON GOING CONCERN AND EXPAND THE AUDITOR'S INVOLVEMENT

Companies need to have effective risk management systems in place to timely identify any risks related to the company's ability to continue as a going concern. We propose to require companies, by standards or legislation, to provide disclosure on the functioning of their risk management systems on going concern.

Currently, the auditor takes account of certain internal control systems, which are part of the risk management systems, within the financial statements audit. In conjunction with this, we believe that the auditor's role should evolve to either provide assurance on the parts of the risk management systems relevant to going concern assessments or that they should be audited within the financial statements audit. This should be considered by standard setters/legislators and then become a requirement. For this to work in practice, auditors might need to consider internal controls over financial reporting as a whole.

### 3. MANDATE GOING CONCERN DISCLOSURE EVEN IF NO UNCERTAINTIES

Current requirements on reporting on going concern are binary, i.e. both companies and auditors are required to provide disclosures only in case of identified material uncertainties. If a material risk on going concern has been mitigated, the disclosure requirements are limited:

- no disclosure is required if there was some material risk that concerned management and the auditors but that has been mitigated in such a way that they believe this to be no longer a material uncertainty on going concern
- only in case of a 'close call' where *significant* judgement by management was needed to assess the sufficiency of the mitigating plans, there is an interpretation (reference is made to footnote 9) that such significant judgement would be disclosed

In all circumstances, we believe that more transparency is needed to provide insights into judgements made which would bring value to stakeholders.

We therefore propose introducing mandatory management disclosure on the basis of their going concern assumption. This should focus on the relevant key judgements of the going concern assessment. Such disclosure should be required even when no material uncertainty is identified. This will require a change in relevant standards. Such disclosure should include a summary of the rationale for how and why management reached their conclusions to support the going concern assumption. Companies should also adequately disclose in their annual report the:

- risks that could impact the company's strategy and business model
- going concern risks resulting from liquidity or solvency issues
- various scenarios tested for resilience
- relevant controls in place which serve to ensure reliable going concern forecasting

Mandatory management disclosure on going concern would contribute to transparency and provide a clear statement to auditors and to wider stakeholders.

Subsequently, auditors should also be required by standards to always provide:

- a statement on their consideration of management's going concern assumption, even in case of no material uncertainty or issues identified with management's assessment
- a conclusion on management's statement that no material uncertainty has been identified

In addition, some countries are considering the idea of 'gradual' or progressive reporting on going concern for both management and auditors. They think that this could replace the current 'pass/fail' outcome of the going concern assessment. Such gradual reporting could provide transparency and valuable insight to stakeholders and could focus on risks, their mitigation and judgements fundamental to the going concern assessment and its outcome. Therefore, we propose that the idea of gradual reporting by management and auditors could be explored by international standard setters and/or EU legislators. The efficiency of such reporting would depend on the use of a clear framework for management and the auditors. It should preferably use and further build on existing concepts to limit the risk of widening the expectation gap.

### 4. CHANGE IN MINDSET, TRANSPARENCY AND COMMUNICATION

This recommendation builds on the above one on enhanced public communicating on going concern.

Companies and auditors have been facing a dilemma between being more transparent about going concern risks and issues, versus fears about potential negative consequences (self-fulfilling prophecy of bankruptcy for a company) of publicly communicating these.

However, stakeholders value insightful information which allows them to make informed decisions. In addition, being transparent demonstrates that a company and auditors have assessed and considered potential going concern risks and issues.

Therefore, we think that companies' and auditors' mindset needs to evolve to move away from fears about negative implications of going concern disclosures. They should rather demonstrate, by disclosing additional information, their knowledge and competency in this area. The current pandemic might accelerate this process as it necessitates different and additional considerations and enhanced transparency towards stakeholders. Naturally, both companies and auditors need to strike the right balance in this regard, i.e. the disclosures should aim to provide useful information but do not need to be exhaustive.

In this context, tone at the top in companies and audit firms is crucial when it comes to commitment towards openness and integrity.

Importantly, disclosures related to going concern made by management and related auditor's communication should provide useful information understandable to stakeholders/market.

### 5. MANDATE AN AUDIT COMMITTEE IN EACH PUBLIC INTEREST ENTITY

According to the EU audit legislation[12], member states may allow a PIE not to have an audit committee in case it has a body that performs equivalent functions.

Given the critical role of audit committees in challenging companies' management and boards and auditors on the issue of going concern, we believe that it should be mandatory for all PIEs to have:

- a separate audit committee independent from management
- a sufficient number of members in the audit committee with competence in accounting and/or auditing (the current EU requirement is to have at least one such member)
- an independent internal audit function supervised by the audit committee

Legislators should abolish provisions that allow member states to derogate from the requirements above.

### 6. CLARIFY AND HARMONISE THE PERIOD FOR GOING CONCERN ASSESSMENT

The period for going concern assessment is currently not harmonised across European countries. This is confusing for users of the financial statements. In some jurisdictions, the assessment is made covering at least 12 months from the balance sheet date, whereas in others it covers 12 months from the date of approval of the financial statements.

This could be partially fixed by mandating disclosure, in the notes to the financial statements, specifying what period management's going concern assessment covers. Eventually, we believe that standard setters and/or legislators should ensure harmonisation of the starting date and length of the period for the assessment which would resolve the issue.

### 7. BROADEN AUDITORS' AREA OF CONSIDERATION AND WORK EFFORT

The above recommendations 2 and 3 already propose broadening of the auditors' work on going concern. For them, there is a prerequisite that new requirements would first have to be introduced for companies and building on that, there could be new requirements for auditors.

To further broaden auditors' work on going concern and to respond to the evolving market needs, audit legislation and/or auditing standards should proactively support the widening role of auditors on going concern. This should enhance auditors'[13]:

- risk assessment adaptability and agility in selecting the most appropriate risk assessment procedures
- work effort in terms of considering more matters and wider context in the evaluation of companies' assessment of going concern, including consideration of relevant contradictory evidence that challenges management's assessment. Auditors should give greater consideration to relevant 'external red flags' in their evaluation of going concern, for example based on information included in analyst reports and relevant developments in the environment in which the company operates
- communication in the auditor´s report on why they agreed with management's assessment of going concern and what they did to satisfy themselves with management's assessment

Broadening auditors' work effort will require auditors to keep enhancing their skills and competences. This relates especially to cash flows, liquidity, financing, (worst case) scenario analysis and (reverse) stress testing in the context of evaluating management's going concern assessment. Moreover, for some areas of work, audit teams might need to use experts, for example, a restructuring expert in case a company needs to undergo restructuring to survive.

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[12] Reference is made to Article 39 of the 2014 EU Audit Directive; available at https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32014L0056

[13] Inspired by the example of the UK ISA 570 (Revised) and outreach calls with experts and regulators from the UK

### 8. MAKE EARLY WARNING MECHANISMS FOR AUDITORS EFFECTIVE

Based on the EU audit legislation[14], auditors are required to notify a dedicated national competent authority if they become aware or discover, in an audit, information likely to jeopardise continuous functioning of a PIE. Auditors do this in addition to informing the company and inviting management to take mitigating actions as required by the ISAs.

We believe that the above alert procedure for auditors should be working more effectively to help prevent corporate failures and enable timely restructuring when insolvency is looming. The problem lies in patchy implementation across European countries and the fact that in many countries, it is unclear which authority the auditors have to report to. Legislators and dedicated competent authorities need to ensure more clarity and harmonisation in this regard. National legislation should specify the competent authority for each type of a PIE and the related procedures for PIE auditors to report such issues.

## BEYOND GOING CONCERN: IDEAS TO BE EXPLORED

In this section, we present ideas proposed by some stakeholders about companies and auditors' potential future role linked with going concern matters and beyond. These ideas provide a wider context for the debate on going concern and are meant to stimulate further debate. They could be explored especially by legislators, including careful consideration of their pros and cons.

### 1. ASSESSING COMPANIES' LONGER-TERM VIABILITY AND RESILIENCE

Longer-term viability and resilience concern a company's ability to adapt to changes to survive and thrive in the long run. Some stakeholders such as investors are calling for more insight into these aspects. This broader context goes beyond the going concern concept which is about the company's ability to survive (financially) in the next 12 months.

The current work of companies and auditors on going concern includes looking 12 months ahead. On top of this work, some stakeholders suggest that legislators could consider introducing a longer-term assessment of PIEs' viability and resilience[15]. This would respond to these stakeholders' calls that consider the current 12 months as a relatively short period. The outcome of such assessment would be a statement(s) which would provide useful information to markets on the strategic flexibility that a company has to respond to changing market conditions.

There are some preconditions for such longer-term viability and resilience statements, which management would prepare. To be effective and useful these would need:

- to include specific and tailored management's disclosures with detail on:
    - which principal risks most impact viability and resilience
    - the stress testing and reverse stress testing performed by management
    - the assumptions used and the outcomes
- to be accompanied by transparent narrative disclosures on the business model and its principal risks
    - non-financial information (NFI) including environmental, social and governance related risks would need to be considered, as many business models are becoming increasingly vulnerable to related risks such as climate change and water scarcity. This links to the idea below in which we propose interconnecting financial information and NFI
- an audit committee's involvement in challenging the scenario analysis and stress testing

[14] Reference is made to Article 12 of the EU Audit Regulation; available at https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32014R0537

[15] In the UK, there is already a requirement for companies to prepare a viability statement but this is not part of the financial statements but other information. There are also proposals for further change by introducing a resilience statement but at the moment, there is little detail on what exactly this would mean

- public oversight bodies' strengthened scrutiny over companies' preparation of the underlying analysis and disclosures
- auditor's involvement which could follow a staggered approach[16]:
  - short-term: going concern assessment with increased transparency which could be subject to audit
  - medium-term: robust and transparent viability statement which may be subject to assurance (on process)
  - long-term: consideration of the risks to resilience on which there would be no assurance

## 2. INTERCONNECTING FINANCIAL AND NON-FINANCIAL INFORMATION

This idea builds on the above one as understanding a company's resilience requires looking at both financial information and NFI.

NFI includes topics such as climate change, depletion of raw materials, access to resources, human rights and social concerns which are increasingly core risks threatening companies' resilience. The term also encompasses internally generated intangibles, which have become a major component of companies' market value.

The impact these topics have on a company affects its ability to create long-term value as companies are dependent on them (e.g. the depletion of raw materials may compromise access to inputs and the production of outputs). An increasing number of stakeholders think that understanding these impacts and dependencies helps in assessing the resilience of the business model and thus the company's going concern ability, and longer-term viability and resilience.

Currently, EU legislation requires only large PIEs to disclose certain information on the way they operate and manage social and environmental challenges.[17] The legislators could consider requiring all PIEs' management to look at both financial information and NFI in order to have a complete picture about the company, including its longer-term sustainability.

Currently, the auditor is required to just perform either an 'existence' or a 'consistency' check of NFI reporting within the financial statements audit of large PIEs. In the future, legislators could consider making assurance on certain parts of NFI reporting mandatory for all PIEs, like it is already the case in a few European countries.

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[16] As inspired by Sir Donald Brydon's proposals for the UK audit market to introduce a Resilience Statement which would incorporate the current UK Going Concern and Viability Statements, for more detail see *Independent review into the quality and effectiveness of audit* (2019); available at https://www.gov.uk/government/publications/the-quality-and-effectiveness-of-audit-independent-review

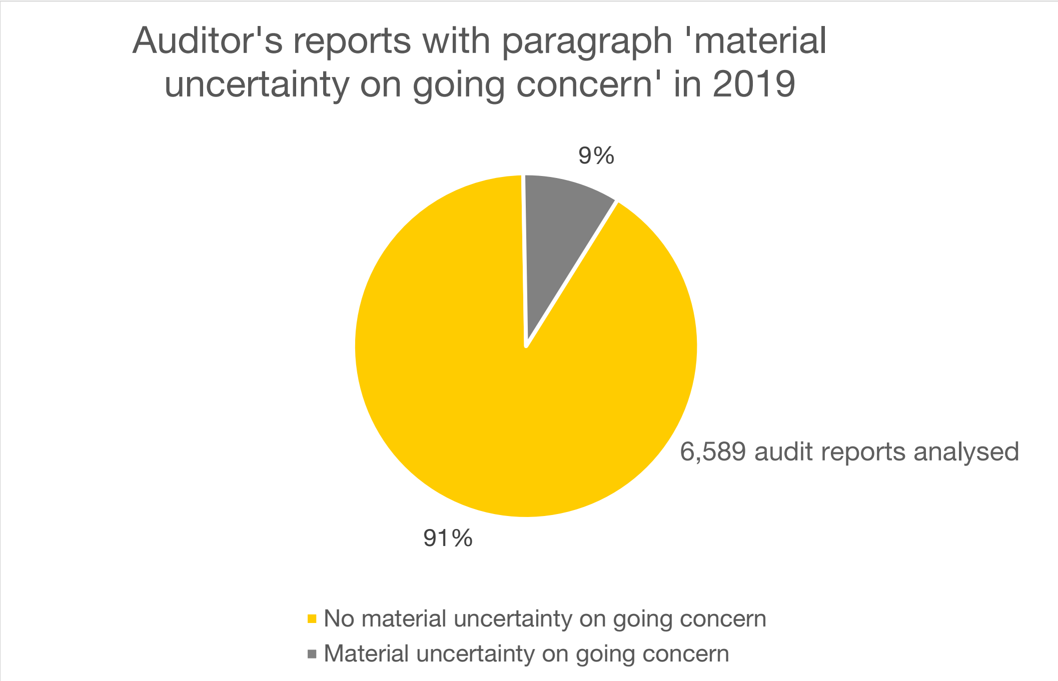
[17] Reference is made to EU Non-financial Reporting Directive 2014/95/EU; more information is available at https://ec.europa.eu/info/business-economy-euro/company-reporting-and-auditing/company-reporting/non-financial-reporting_en

# APPENDIX: ANALYSIS OF AUDITOR REPORTING ON GOING CONCERN IN 2019

For our analysis, we used the Audit Analytics database[18] which includes data on companies listed on European exchanges[19]. We have looked into the auditor reporting on going concern related to the financial year 2019[20].

## MATERIAL UNCERTAINTY ON GOING CONCERN

Number of auditor's reports on companies which include a 'material uncertainty on going concern'[21]:




In 2019, there were 603 companies for which the auditor concluded there was a material uncertainty about their ability to continue as a going concern. This represents around 9% of the analysed companies.

By examining the auditor's reports on these companies[22], we were able to identify that almost half of the companies with a material uncertainty on going concern in 2019 had difficulties with staying in business due to the pandemic's impact. Note that audits related to financial year 2019 were carried out in the first half of 2020 when the pandemic was already spread all over the world.

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[18] https://www.auditanalytics.com/0004/

[19] In the analysis, we included data on 30 countries: EU-27, Norway, Iceland and the United Kingdom. All data was downloaded in October 2020

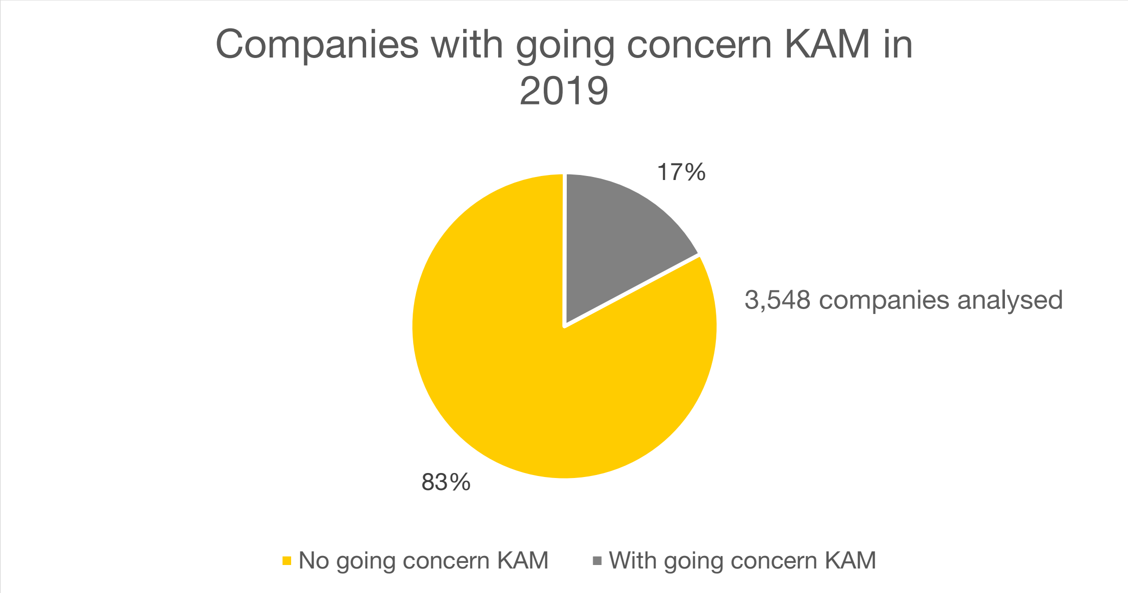
[20] Audit Analytics database on Europe currently includes going concern data for financial years ending 30 September 2019 and later. Such data on earlier years is not yet available but will be added in the future

[21] This analysis was done on a sample of yearly data on listed entities as included in the Audit Analytics database 'Audit opinions', i.e. we analysed data on 6,589 auditor's reports on listed entities

[22] Note that we have used online tools for translation of the auditor's reports in foreign languages which might have had an impact on the accuracy of our understanding of the content. Some auditor's reports' text in foreign languages could not be copied and subsequently translated. In such cases, we could not look into the existence of a link with the pandemic

## GOING CONCERN AS A KEY AUDIT MATTER

Number of companies with going concern as a KAM[23]:




In 2019, there were 610 companies for which the auditor included a KAM on going concern in the auditor's report. This represents around 17% of the analysed companies.



[23] This analysis was done on a sample of yearly data on listed entities as included in the Audit Analytics database 'Key Audit Matters', i.e. we analysed data on 3,548 listed entities. The Key Audit Matters database includes only companies for which there was at least one KAM reported by the auditor (in the English language). This means that 3,548 companies we analysed on KAMs constitute a subset of the sample of 6,589 in the analysis above on material uncertainty on going concern

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