The Potential Impact of Covid-19 on Audits - ISA (Ireland) 570 – Going Concern

by Umesh Rana

ISA 570 was released In October 2019. There are now additional requirements for directors and auditors. For the auditor this includes an independent assessment of the entity's ability to continue as a going concern. This includes obtaining an understanding of the entity and its environment and its internal control system. The auditor will also need to assess how the entity identifies and address risks.

There are more stringent requirements regarding documentation.

Under the current circumstances, with a worldwide pandemic raging, I believe that this auditing standard will be extremely important. A lot of entities will probably go out of business during the pandemic, some will never reopen, and many will face material uncertainties regarding going concern.

Financial statements are prepared on a going concern basis of accounting unless management either intends to liquidate the entity or to cease business operations or has no realistic alternative but to do so. The going concern basis of accounting should be used even if there are material uncertainties that exist but these will need to be adequately disclosed; more on this later. It is management's responsibility to assess the entity's ability to continue as a going concern.

The term "ability to continue as a going concern" is equivalent to the term "ability to continue to adopt the going concern basis of accounting" in the future.

This involves making a judgement at a particular point in time and must involve all known facts and conditions that exist at that point in time. This might also involve material uncertainties whose outcome and/or monetary values, might not be predictable at that point in time. Examples of these could be the outcome of pending litigation or renegotiation of credit facilities with a financial institution many months later after the approval of the financial statements and the audit report date.

On the other hand, the auditor's responsibility is to be able to obtain sufficient and appropriate evidence and conclude on the appropriateness of management's use of the going concern basis and whether a material uncertainty exists about the entity's ability to continue as a going concern. The auditor cannot predict future events and in the absence of no reference to a material uncertainty does not mean that the auditor guarantees that the entity will continue its operational existence in the future.

I remember arguing with some members of the public who were criticising auditors as "useless" when the financial crisis that started in September 2008, with the collapse of Lehman Brothers in the USA. Their point was how could auditors have given all the Irish banks a clean audit report when they collapsed some months later? How many could have foreseen in the first half of 2008, that a worldwide financial crisis would occur in the second half of 2008 and that the Irish banks would collapse?

As part of planning and performing risk assessment procedures, the auditor should consider if there are events or conditions that may cast a doubt on the entity's ability to continue as a going concern. Included in this assessment is obtaining an understanding of the entity and its environment such as the business model, its operations, financial performance etc.

The auditor should also evaluate the internal control system such as how the entity identifies business risks and takes steps to address them. If management have already performed these procedures, he should discuss these with management.

Some examples of these are as follows:

Net current liability position, adverse key financial ratio's, non-compliance with loan covenants, unplanned sale of non-currents assets, labour difficulties uninsured catastrophic events etc.

When the auditor is evaluating management's assessment, a high level of professional scepticism should be maintained throughout. The auditor must ensure that management have considered all known and relevant factors and there are no indicators of management bias.

The assessment period for going concern should be not less than twelve months from the date of approval of the financial statements. If the period of assessment is less than twelve months, this should be disclosed in the notes. If this shortened period is not disclosed the auditor will consider disclosing this fact in the "Basis of Opinion" paragraph.

If management have not made the assessment for going concern, the auditor should request them to do so. If management are unwilling to make the assessment, as management determine that they do not need to prepare detailed cash flow and other forecasts, the auditor will have to use judgement to evaluate if this constitutes lack of appropriate evidence. Adequate documentation is always required in audit files. The auditor will have to consider impact on the opinion if it constitutes insufficient evidence (qualified or disclaimer).

If events or conditions have been identified which may cast a doubt on the entity's ability to continue as a going concern, the auditor must perform additional procedures which must include the following:

The auditor is required to obtain adequate support from the directors for the going concern assessment including methods, assumptions and sources and the reliability of data used in the forecast.

- The auditor will need to evaluate how the directors have determined the relevance, accuracy and reliability of data used.
- Maintain professional scepticism and ensure that there is adequate support for assumptions used.
- Evaluate management's future plans and assess whether the plans are feasible.
- Consider any additional information that may have become available since the date that management prepared the forecast.
- Request a written representation from those charged with governance about their future plans and feasibility of those plans.

Additional procedures might include:

Consider if management have taken into account all relevant information regarding the cash flow forecast. For instance if they are showing increased sales, have they considered the increase in utility bills, additional material and labour costs?

Review previous years forecasts and compare it to actual numbers as this will provide additional evidence in terms of how accurate the assumptions were.

Where a material uncertainty exists (when the magnitude of the potential impact of the event or condition and the likelihood of occurrence is such) that this must be adequately disclosed.

To assess adequacy of disclosure the following must be covered in the disclosure:

- Description of the principal events or conditions that may cast a significant doubt about the entity's ability to continue as a going concern.
- Management's plans to deal with these events or conditions.
- Disclose clearly that there is a material uncertainty related to the events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.
- Entity may be unable to realise its assets and discharge its liabilities in the normal course of business.

If adequate disclosure is made, the auditor will not modify the opinion. He will include a separate section that follows the basis of opinion paragraph. Its heading will be "Material Uncertainty Related to Going Concern". The auditor will draw attention to the note disclosure and state that a material uncertainty exists that may cast a significant doubt on the entity's ability to continue as a going concern and that the auditors opinion is not modified in this respect.

In the event that the auditor has qualified his opinion on a different matter, the above paragraph will be modified to say that the auditor's opinion is not further modified in this respect.

If the auditor considers that no disclosure is made or if the disclosures are inadequate, the opinion will be modified (qualified or adverse).

Further, in the "Basis for Qualified (Adverse) Opinion" section of the auditor's report, it will state that a material uncertainty exists and that the financial statements do not adequately disclose this matter.

If the auditor believes that management's use of the going concern basis of accounting is inappropriate, there is only one opinion – Adverse!

In situations where there are multiple uncertainties that are significant to the financial statements the auditor in rare circumstances, will express a disclaimer of opinion.

If the auditor agrees that the going concern basis is appropriate, the auditor will include a section in the auditor's report headed "Conclusions relating to Going Concern" and state amongst other requirements that no material uncertainty exists and that the going concern basis of accounting is appropriate.

As usual, documentation is of paramount importance. The auditor should include key elements of the understanding of the entity and its environment, indicators of any management bias, whether or not a material uncertainty exists and the appropriateness of management's disclosures in the financial statements.

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