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UK audit watchdog sets out new standards on going concerns

The UK Financial Reporting Council (“FRC”) has (on 30 September) issued a revised standard (International Standard on Auditing (UK) 570 – “the Standard”) to be applied by auditors when assessing whether entities are viable as going concerns. The changes to the Standard, which take effect in respect of audits of financial statements for periods commencing on or after 15 December 2019 (or earlier if companies and auditors choose to apply them), require auditors more robustly to challenge assurances given by management about entities’ ability to continue trading.

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As if to underline the FRC’s reasons for amending the Standard, the announcement of the changes, which were the subject of a lengthy consultation exercise earlier this year, coincided with the collapse of the latest in a line of UK household name companies.

What has changed?

The FRC has identified a lack of “professional scepticism” about whether entities may properly be treated as “going concerns” as a key theme in a number of its most high profile enforcement cases against firms and individuals in recent years. This theme is now more formally reflected in the Standard.

Auditors are now required to challenge more forcefully management’s assessment of the ability of entities to continue as going concerns and to provide a clear, positive conclusion on whether management’s assessment is appropriate, setting out the work done in support of that conclusion. There is also now an explicit requirement for auditors to “stand back” and consider all evidence obtained during an audit, whether corroborative or contradictory, before drawing conclusions about whether an entity will be able to continue as a going concern.

The enforcement landscape

As the FRC prepares for the transfer of its enforcement functions to a new body (the Audit, Reporting and Governance Authority, or “ARGA”), enforcement action in relation to audits is on an upward trajectory. The FRC’s most recent published enforcement statistics show that the vast majority of the £42.9 million in fines it imposed on firms during 2018/19 related to audit failings. It fined individual audit partners a further £1.2 million during that period. The FRC has also shown an increasing readiness to use non-financial sanctions against both firms and individuals. For audit firms, this has meant measures including the imposition of monitoring and reporting requirements, enforced changes to audit methodology and requirements to staff audits with multiple partners. For individuals, this has involved exclusions from involvement with audit activity for up to 15 years.

Fines and other sanctions imposed by the FRC are not of the same order of magnitude as those imposed on banks and corporates in other contexts, but the impact of them in terms of business disruption and damage to individual and corporate reputations is nonetheless significant.

The FRC is making regular use of the Audit Enforcement Procedure (“AEP”), which was introduced in June 2016, to provide a more targeted and efficient means of taking action against audit firms and individuals within them. Twelve of the fifteen enforcement investigations which the FRC opened during 2018/19 were pursued under the AEP. The changes to the Standard have been made at a time when levels of public and political concern about the role of auditors in testing the statements and assumptions of companies’ management are high. The FRC is bolstering resources devoted to enforcement by recruiting an additional 80 staff. There is substantial political support for ARGA to receive further enhanced enforcement powers. Against this backdrop, the numbers of enforcement cases concerning audit activity and the size of penalties imposed both look set to continue to rise.

Practical points

- The Standard will not apply globally. The FRC has indicated that it has held discussions with its counterparts in Australia, Canada and Japan about whether they may implement similar revisions. As matters stand though, it imposes significantly more stringent requirements in the UK than are in place in other jurisdictions. Firms will wish to ensure that their methodologies, policies and procedures make clear when the Standard will apply and what is required under it.
- The revisions to the Standard, coupled with the intensifying enforcement environment, underline the importance of thorough and effective record keeping. In order to be able to defend the often quite subjective judgements now required under the Standard, it is more important than ever for firms and individuals to record clearly the steps taken to test statements made by management and overall assessments that entities are viable as going concerns.
- Enforcement action by the FRC in relation to audit issues rarely takes place in isolation. Investigations concerning the conduct of auditors under the AEP will frequently overlap with those of, for example, the Financial Conduct Authority (including in its role as the UK Listing Authority) and/or the Serious Fraud Office concerning the conduct of the audited entity and its executives. Particular challenges may arise from obligations to produce documents or provide information to one authority which may then be passed to and used by another. Audit firms should be prepared for detailed discussions with the FRC (and, in due course, ARGAs) and other authorities to ascertain whether they are being compelled to provide information (and, if so, on what basis), to which authorities it may be passed and what subsequent use may be made of it.