

cpab exchange

Going concern thematic review

The financial health and ability of reporting issuers to continue as a going concern is important information for users of financial statements. Our current review coincides with continuing uncertainty arising from geopolitical developments, supply chain disruptions and other events and conditions that could affect future outcomes.

The auditor's responsibilities are to obtain sufficient appropriate audit evidence regarding, and conclude on, the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements; and to conclude whether there is a material uncertainty about the company's ability to continue as a going concern.

The Canadian Public Accountability Board (CPAB) has maintained an open dialogue with standard setters and others since our 2019 going concern thematic review. In 2021, we performed a second thematic review on going concern. Our objectives were to gather factual, evidence-based data that could be shared with standard setters and encourage the adoption of good practices by auditors to enhance the protection of the public interest.

EXECUTIVE SUMMARY

We found an improvement in the quality and consistency of auditor's work performed on going concern since our last thematic review. However, auditors can do more to proactively assess going concern risk and apply professional skepticism consistently. It is imperative that auditors identify early warning indicators, challenge management and assess the quality of management's disclosures.

More robust and detailed guidance would improve consistency between auditors and management on how to approach the assessment and disclosure of going concern uncertainties and particularly in close call situations.

We encourage standard setters to consider our observations to determine what further action they should take on going concern.

This paper is organized into three sections. In **Section 1**, we discuss how auditors could do more to assess going concern where risk is heightened. In **Section 2**, we provide more details on auditor good practices we observed. In **Section 3**, we consider the alignment of auditing and accounting standard setters in the context of our findings.

SCOPE OF REVIEW

In 2019, we performed a limited scope review of the audit files of a sample of 11 Canadian reporting issuers where management (and the auditor's report) did not disclose a going concern risk, but the reporting issuer had shown evidence of recent financial difficulties based on publicly available information.

In 2021, the pandemic and other macroeconomic factors presented new financial challenges to reporting issuers. Accordingly, we gathered information on the auditor's response to going concern risk for 121 of our 2021 inspections.

WHAT WE FOUND

We continued to see instances of audit firm good practices in the following areas, though they were not done consistently across the 121 inspections:

- How going concern was addressed in client acceptance or continuance.
- How the audit team evaluated management’s assessment of going concern.
- Communication with those charged with governance.
- The consistency of the going concern evaluation with other parts of the audit file including auditing accounting estimates.

We also performed a focused evaluation of the quality of audit work performed for going concern for 35 of the 121 inspections where management and/or audit firms identified heightened going concern risk. We categorized these higher risk files as follows:

Category	Description	# of files
I Close calls — events or conditions and no material uncertainty	Events or conditions were identified that may cast significant doubt on the reporting issuer’s ability to continue as a going concern, but the auditor concluded that they did not rise to the level of material uncertainty. The auditor is required to evaluate whether the disclosures in the financial statements provide adequate disclosures about the events or conditions as required by the applicable financial reporting framework (a close call scenario).	7
II Going concern disclosures	Events or conditions were identified that may cast significant doubt on the reporting issuer’s ability to continue as a going concern and the auditor concluded that material uncertainty exists. Management disclosed material uncertainties related to events or conditions that may cast significant doubt on the company’s ability to continue as a going concern, and the auditor’s opinion included an emphasis of matter related to going concern.	28
Total		35

We observed weaknesses in the adequacy of going concern-related disclosures in four of the seven close calls.

SECTION 1 — HOW CAN AUDITORS DO MORE WHERE THE RISK OF GOING CONCERN IS HEIGHTENED?

Auditors need to do more to consistently assess going concern and challenge management where events or conditions are identified that cast doubt on the entity's ability to continue as a going concern.

In the seven close call files, where the auditors concluded there was no material uncertainty related to going concern, we observed weaknesses in how risk was assessed,¹ how professional skepticism was exercised, and, for four of the close call files, the quality of disclosures². There was also a lack of evidence of two-way dialogue with those charged with governance on important issues related to going concern.

A clearer link between the current going concern standard and other auditing standards would improve audit consistency. The auditing standard could clarify what is expected from auditors in performing a risk assessment with respect to going concern, in challenging management proactively, in considering contradictory evidence and in standing back to assess corroborative and contradictory evidence before concluding. Revisions would need to align with the current auditing standards on risk assessment and accounting estimates.

Clearer guidance is also needed on how to identify and evaluate close calls, and when earlier communication with management and audit committees is warranted. The guidance should also provide examples to illustrate how auditors should weigh the need for key audit matter disclosures, for instance when going concern issues recur in multiple periods.



Risk assessment

The auditor is responsible for understanding the issuer, its environment and its system of internal control. A robust risk assessment enables the auditor to obtain information that is relevant to identifying heightened going concern risk.

For six of the seven files where the risk of going concern was heightened but not disclosed, we observed the following:

- In three of the files, the auditor did not obtain an understanding of the entity's risk assessment process.
- In one of the files reviewed, the engagement team did not demonstrate an understanding of the entity's business model, objectives and strategies, such as how the entity was structured and financed.
- In two of the files, the engagement team did not obtain an understanding of management's budgeting and forecasting process, nor did they evaluate management's ability to forecast.
- In four of the files, there was no review of the nature and extent of oversight and governance over management's assessment of the entity's ability to continue as a going concern.

The lack of evidence of comprehensive risk assessments could make it more challenging for auditors to identify going concern risk early in the audit process.

¹ISA 315 — *Identifying and assessing the risks of material misstatement* (Revised) — effective beginning on or after December 15, 2021). The revised standard was not effective for the files we examined, but could result in future improvements in the quality of the auditor's risk assessment of going concern.

²ISA 540 — *Auditing accounting estimates and related disclosures*.



Exercising professional skepticism

We observed inconsistencies in the work performed by auditors to exercise professional skepticism in their review of the forward-looking estimates prepared by management.³

- In four of the files, no stand back assessment was performed.
 - In two of the files, there was no evidence that the engagement team evaluated the quality of external information and analysis.
 - In two of the files, there was no evidence that the engagement team evaluated the consistency of the going concern assessment with management's discussion and analysis of liquidity, covenants, sensitivities and other going concern-related disclosures.
- In three of the files, sensitivity analyses were not performed, and management was not requested to expand their cash flow forecasts to include other realistic scenarios to further support their conclusion.

Management may find it difficult to remain objective in performing their assessment when their entity is experiencing close call events and conditions. They may view going concern disclosures as self-fulfilling and therefore not in the best interests of the business.

The identification of potential management biases may better enable the auditor to be alert to evidence that could challenge and contradict management's assertion. We believe that the current standard could be improved by requiring a presumption of bias.



Quality of disclosures

For four of the close calls, the significant judgments used to conclude that there were no material uncertainties were not clearly disclosed⁴ by management or lacked specificity. Examples of disclosure issues included:

- In one instance, audit documentation noted that there were no material uncertainties, but that significant judgment was involved to reach this conclusion due to the potential understatement of a liability. The disclosure noted the possibility that the liability could be higher, but not the specific significant judgments that were required to conclude.
- Disclosures lacking entity-specific information about mitigation plans to assist the reader in understanding the close call vs. material uncertainty determination.
- Disclosures lacking references to the external financial support that was required to ensure the solvency of the business as a going concern. External debt and equity financing were announced shortly after the audit opinion date and noted in subsequent interim financial statements.
- Disclosures identifying uncertainty in the sector and factors relating to liquidity risk and capital management, but lacking references to mitigation plans, and financial support required from external parties to conclude that material uncertainty did not exist.

For all four close calls, there was no evidence to demonstrate that the auditor evaluated the adequacy of the financial statement disclosures. There was also no evidence that the auditor's significant judgments in concluding that no material uncertainty existed, or management's ambiguous or imprecise disclosures, were reported to the audit committee.

³ While the items in this section are not specifically required by CAS 570, they are required by another auditing standard, CAS 540, *Auditing accounting estimates*, and should be considered as part of the auditor's evaluation of management's going concern assessment.

⁴ International Accounting Standard 1, paragraph 7, provides guidance on how material information should be disclosed.



Quality of communication of going concern with audit committees

As noted above, we expect robust discussions with the audit committee on going concern where significant judgment is required. However, there was no evidence of any dialogue between audit committees and the auditor on going concern for a number of these files, including two files where the engagement team considered going concern as a potential key audit matter.




Going concern auditing standard enhancements in the United Kingdom

The quality of the auditor’s going concern evaluation needs to improve. One way to achieve this would be through strengthening the auditing standards. Our observations on weaknesses in auditing practices have already been addressed by new requirements adopted in the UK, but they have not been implemented elsewhere.

We encourage the international auditing standard setter⁵ to review the effectiveness of these changes as they proceed with their going concern project.

SECTION 2 – AUDIT FIRM GOOD PRACTICES

We identified auditor good practices across a number of the files we inspected. Here are some illustrative examples to give auditors more insight into what we specifically observed.

Audit firm good practices	
 <p>Firm leadership included going concern as a factor in determining high-risk audits</p>	<p>Increased going concern risk was included as a factor to evaluate in the audit firm’s acceptance and continuance form.</p>
 <p>Escalation of going concern risk as part of annual approval process, and involvement of firm leadership</p>	<p>The engagement team identified an increase in going concern risk and obtained firm leadership approval of the continuance form.</p>
 <p>Audit team consulted with subject matter experts</p>	<p>Subject matter experts, such as corporate finance, restructuring, valuation, professional practice and tax specialists, participated in a formal consultation on going concern.</p>

⁵In Canada, the Auditing and Assurance Standards Board adopts the International Standards on Auditing as Canadian Auditing Standards.

Audit firm good practices



Continuous assessment

The audit team evaluated changes in the business conditions throughout the year and their potential impact on their assessment, and kept firm leadership informed when going concern risk changed.



Stand back

A stand back analysis was performed to evaluate contradictory evidence or appropriately challenge management to provide a more robust assessment. A stand back assessment requires the auditor to take into account all of the evidence obtained, whether corroborative or contradictory, and conclude whether they obtained sufficient appropriate audit evidence regarding going concern.



Proactive communication of risk, and changes in risk, to audit committee

Going concern was reported to the audit committee as a potential key audit matter in their audit plan. When the issuer's liquidity materially improved, the engagement team reduced going concern to a normal risk, and this change was communicated to the audit committee.



Audit procedures to assess reliability of budget to actual forecasting process

Detailed walkthroughs and control testing were performed on the issuer's annual budget process and cash flow monitoring and forecasting.



Challenging management with external corroborative and contradictory evidence

The engagement team reviewed external data to verify the timing and magnitude of the cash flow recovery through direct comparison to third party projections.



Challenging management on alternative scenarios, including severe but plausible downside scenarios

- The engagement team performed a sensitivity analysis over the available liquidity applying the worst historical performance experienced to confirm that liquidity would be sufficient.
- The engagement team stress-tested for worst case scenario, performing a reverse stress test⁶ to confirm the sufficiency of liquidity.



Key considerations guidance

Several audit firms required engagement teams to summarize COVID-19 key considerations as part of their risk assessment. This additional process encouraged teams to provide thoughtful responses to identify events or conditions that could impact going concern and assess contradictory evidence. Teams were reminded to be alert to new information post-year end, and to update their assessment to the date of the audit report, as required by the current standards.

⁶Per the Institute of Chartered Accountants in England and Wales, "A reverse stress test is a stress test that starts from the opposite end, with the identification of a pre-defined outcome. This might be the point at which an entity can be considered as failing, or the entity's business model becomes unviable. Severe, but plausible, scenarios that might result in this outcome are then explored".

SECTION 3 – GOING CONCERN AND ACCOUNTING AND AUDITING STANDARDS

Stronger alignment is needed between the auditing and accounting standards to enhance the quality of financial reporting. Management and auditors may need to apply significant judgment in assessing going concern, but there is a lack of clear and harmonized guidance to ensure they are approaching these judgments consistently.

More robust definitions of material uncertainty in both the accounting and auditing standards would improve consistency between management and auditors in how to approach close calls. Accounting and auditing standard setters might consider exploring evaluation and disclosure of an entity's resilience to threats to its longer-term viability as an alternative to the binary assessment of whether material uncertainty exists to assess its prospects. They could also provide more guidance to clarify what is required of management when they experience close calls.

In the audit files reviewed, we found instances where auditors needed to ask management to prepare assessments or do significantly more work. This was also sometimes the case when disclosures were required:

- For two of the seven close calls, the engagement team had to ask management to prepare a going concern assessment.
 - Where going concern disclosures were required, 11 per cent of auditors had to ask management to prepare an assessment.
- For one of the seven close calls, management was asked to perform significant additional work.
- For six of the 28 files where going concern was disclosed, there was no evidence that management prepared a going concern assessment projecting 12 months beyond the date of issuance of the financial statements.

Auditors were unable to consistently obtain evidence that management had assessed the risk of going concern in their preparation of the financial statements, prior to the audit, or identify management controls to monitor significant changes in going concern. There is also a lack of clear guidance for management to understand what close calls are, and what they are required to do when their entity is experiencing a close call. The current guidance for close calls in accounting⁷ standards is not contained in the standards themselves, is limited in nature and challenging to find. More detailed guidance within the accounting standards could result in better quality work by management, and lead to better quality audit work.

⁷Close calls are considered, and some guidance is provided, in the July 2014 International Financial Reporting Standards Interpretation Committee Agenda Decision. However, this information is not currently in the accounting standards and there is a risk that entities may not be aware they need to provide them.

WHAT'S NEXT?

We have seen improvements in how auditors are assessing going concern since our last review. There is also an opportunity for auditors to be more proactive and consistent in how they assess and evaluate going concern risk.

One way to achieve enhanced consistency would be to strengthen auditing, accounting and corporate reporting standards for going concern, and provide incremental corporate disclosure, standards, procedures and education.

We invite auditors, standard setters and other stakeholders to continue the dialogue with CPAB on this important matter.

ABOUT CPAB

CPAB is Canada's public company audit firm regulator charged with protecting the investing public's interests. CPAB oversees public accounting firms that audit Canadian reporting issuers. Our thematic reviews promote audit quality through practicable insights that inform capital market participants, including standard setters, and contribute to public confidence in the integrity of financial reporting.

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