VIEWS & IDEAS

ACCOUNTANCY EUROPE.

Going concern: RECOMMENDATIONS TO STRENGTHEN THE FINANCIAL REPORTING ECOSYSTEM

BACKGROUND

When a company collapses, all stakeholders are affected, from employees to investors, and it eventually erodes the public's trust in financial markets. Our publication *Going concern: recommendations to strengthen the financial reporting ecosystem* 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.

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. Our publication aims to make the system more resilient by re-examining the role of key parties: inside the company, external auditors, standard setters, legislators and public oversight authorities.

Assessing a company's ability to continue as a going concern has its inherent limitations as such assessment is based on forecasts and cannot foresee all future events. The pandemic has showed us that preventing all corporate failures is not possible. However, a stronger financial reporting ecosystem could enable entities to timely adopt preventative measures or better manage the implications of these failures.

Fraud and going concern issues are often correlated. We also developed recommendations in our publication *Fraud: recommendations to strengthen the financial reporting ecosystem*.

RECOMMENDATIONS FOR A STRONGER FINANCIAL REPORTING ECOSYSTEM

Our recommendations focus on financial reporting and audit of European public interest entities (PIEs). However, some may also be relevant for non-PIEs and their auditors. The recommendations start from the requirements in relevant international standards and EU legislation.

OUR MAIN PROPOSALS

Broaden companies' work effort

Standards and/or relevant legislation need to broaden companies' work effort on going concern assessments. Companies should implement integrated systems and have adequate procedures to prepare reliable cashflow forecasts. They should also stress test and reverse stress test the validity of their going concern analysis. Management should have the necessary education, competences and skills to prepare such forecasts and analyses.

Mandate disclosure on companies' risk management systems on going concern and expand the auditor's involvement

Standard setters and/or legislators should require companies to provide disclosure on the functioning of their risk management systems on going concern. The auditor's role should evolve to either provide assurance on these parts of the risk management systems, or these should be audited within the financial statements audit. For this to work in practice, auditors might need to consider internal controls over financial reporting as a whole.

Mandate going concern disclosure even if no uncertainties

We propose introducing mandatory management disclosure on the basis of its 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.

Subsequently, standards should require auditors 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

Some countries are considering the idea of 'gradual' reporting on going concern for both management and auditors. International standard setters and/or EU legislators could also explore whether this could replace the current 'pass/fail' outcome of the going concern assessment.

Change in mindset, transparency and communication

Companies' and auditors' mindsets need to move away from fears about negative implications of going concern disclosures. Both should rather demonstrate their knowledge and competency in this area through disclosing additional information. Management's disclosures and related auditor's communication should not be boilerplate, but should instead provide useful information understandable to stakeholders.

Mandate an audit committee in each public interest entity

It should be mandatory for all PIEs to have a separate audit committee that is independent from company's management. This committee should have a sufficient number of members with competence in accounting and/or auditing. Legislators should abolish provisions that allow EU Member States to derogate from these requirements.

Clarify and harmonise the period for going concern assessment

Standard setters and/or legislators should mandate a disclosure specifying what period management's going concern assessment covers. We believe that they should also ensure harmonisation of the starting date and length of the period for the assessment across European countries.

Broaden auditors' area of consideration and work effort

Audit legislation and/or auditing standards should proactively support the widening role of auditors on going concern. This should enhance auditors':

- risk assessment adaptability and agility
- work effort in terms of considering wider context in evaluating companies' assessment of going concern, including relevant contradictory evidence that challenges management's assessments, external red flags and analyst reports
- 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 it

Make early warning mechanisms for auditors effective

Alert procedures for auditors should be more effective to help prevent corporate failures and enable timely restructuring when insolvency is looming. Legislators and dedicated competent authorities need to ensure more clarity and harmonisation across Member States. National legislation should specify the competent authority for each type of PIE and the related procedures for PIE auditors to report such issues.

BEYOND GOING CONCERN: IDEAS TO BE EXPLORED

Assessing companies' longer-term viability and resilience

The current work of companies and auditors on going concern focuses on the next 12 months. Some stakeholders suggest that on top of this, legislators could consider introducing a longer-term assessment of PIEs' viability and resilience. This would concern a company's ability to adapt to changes to survive and thrive in the long run. Viability and resilience statements would be prepared by management and the auditor's involvement could follow a staggered approach, i.e. with more involvement in the short-term assessments.

Interconnecting financial and non-financial information

Understanding a company's resilience requires looking at both financial information and non-financial information (NFI). Legislators could consider requiring all PIEs' management to consider financial information and NFI to have a complete picture about the company. Legislators could also consider mandating assurance on certain parts of NFI reporting for all PIEs.

SEND US YOUR FEEDBACK!

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.