Covid-19

Going concern in the public sector

Guide for auditors

AUDIT SCOTLAND

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Introduction

1. Covid-19 has already had a significant impact on every aspect of society in Scotland. It has affected individuals and communities, public services and the economy. Scotland's public bodies are at the forefront of the response, working with their partners to address the social and economic impact on communities across the country.

2. Public bodies were already under pressure from increasing costs and increasing needs from communities before the pandemic. Covid-19 brings additional financial demands and pressures on budgets.

3. In the current context, particularly where public bodies and related organisations are facing extreme financial challenges, we are receiving many enquiries about whether it is appropriate for auditors to report matters related to going concern for public bodies.

This guide

4. This guide sets out how the concept of the going concern basis of accounting applies in the public sector. It has been prepared by Audit Scotland's Professional Support in response to auditor enquiries and is part of Audit Scotland's ongoing series of publications on Covid-19 related matters.

5. The guide explains auditors' responsibilities and differentiates going concern considerations from financial sustainability. It complements the more detailed operational guidance on financial sustainability that supplements the Code of Audit of Practice.

6. In order to understand how going concern applies in the public sector, it is helpful to consider the different financial reporting and auditing frameworks in the private sector and the rationale that underlies them. This guide therefore summarises the private sector situation to help auditors understand the distinctive going concern position in the public sector.

7. The guide has been prepared with public sector auditors as its primary audience. Auditors are encouraged to discuss the issues in this guide with the organisations they audit. Please note that some hyperlinks link to documents in Audit Scotland's Technical Reference Library and are therefore active only for auditors.

8. Auditors have also raised questions in respect of the requirement for councils to set a balanced budget. A separate guide in this Covid-19 series, Balancing the budget in councils, deals with that matter.

Contact point

9. The contact point in Professional Support for this guide for auditors is Paul O'Brien – pobrien@audit-scotland.gov.uk

Going concern in the private sector

Going concern – the concept and principles

10. The term 'going concern' applies to any entity unless its management intends to liquidate the entity or to cease trading or has no realistic alternative to doing so.

11. The ability of an entity to continue as a going concern means the ability to continue to adopt the going concern basis of accounting in the future.

12. Under the going concern basis of accounting, the financial statements are prepared on the assumption that the entity will continue its operations for the foreseeable future. Assets and liabilities are recorded on the basis that the entity will be able to realise its assets and discharge its liabilities in the normal course of business.

13. Where an entity is to be liquidated or cease its operations, the assets' recoverable values may be significantly less than the carrying amount in the balance sheet. In order for the financial statements to give a true and fair view, the assets and liabilities would have to be measured on a 'break up' basis.

14. The international financial reporting standard which covers the going concern basis of accounting is IAS 1. Paragraph 25 of IAS 1:

- requires the management of an entity to make an assessment of an entity's ability to continue as a going concern
- requires an entity to prepare financial statements on a going concern basis unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so
- requires the entity to disclose any material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern.

15. Paragraph 26 of IAS 1 explains that the assessment of whether the going concern assumption is appropriate should take into account information about the future which is at least twelve months from the end of the reporting period.

16. Paragraph 26 also explains that the degree of consideration depends on the facts in each case. When an entity has a history of profitable operations and ready access to financial resources, the entity may reach a conclusion that the going concern basis of accounting is appropriate without detailed analysis.

The auditor’s responsibilities

17. The relevant auditing standard is ISA (UK) 570. It provides an interpretation of the term going concern on page 2 by explaining that:

- the term applies to any entity unless its management intends to liquidate the entity or to cease trading, or has no realistic alternative to doing so
- the phrase in IAS 1 ‘ability to continue as a going concern’ means ‘the ability to continue to adopt the going concern basis of accounting’.

18. The auditor's responsibilities are to conclude on:

- whether a material uncertainty related to the use of the going concern basis of accounting exists; and
- the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements.

19. These responsibilities apply even if the financial reporting framework used in the preparation of the financial statements does not include an explicit requirement for management to make a specific assessment of the entity's ability to continue as a going concern.

20. The collapse of high-profile companies led to revisions to ISA (UK) 570 in 2016 which require auditors to report by exception in the Independent Auditor’s Report as to whether the going concern basis of accounting was appropriate and whether there were any material uncertainties.

Going concern in the public sector

21. The concept of going concern is applied in a different way in the public sector. Public bodies exist to deliver essential public services. It is reasonable to presume that those services will continue to be delivered using the same assets unless there is evidence to the contrary. This presumption continues to hold even where responsibility for delivery is transferred by the government to another body or bodies.

22. In determining the appropriateness of the going concern basis of accounting, the continued use of the assets to deliver services is more important than the continued existence of a particular public body.

Public sector financial reporting and going concern

23. The financial framework in the public sector recognises the presumption of the continuation of public services as follows:

- In local government, the Code of Practice on Local Authority Accounting in the UK requires the going concern basis of accounting to be adopted unless a body can be wound up without legislation in which case IAS 1 applies

- In other sectors, the Government Financial Reporting Manual also requires a going concern basis other than, for example, where a body is being wound up in which case there is a need to consider if the functions are to continue.

24. In the public sector, management's use of the going concern basis of accounting is driven by the requirements of the financial reporting framework (which presumes the continuation of service provision) rather than the financial sustainability of a particular body.

25. This means that management's assessment of the appropriateness of the going concern basis of accounting required by IAS 1 will be straight-forward (as provided for by paragraph 26 of IAS 1 highlighted earlier in this note). Other than in exceptional cases (eg, where a body's functions are to be discontinued or delivered outside the public sector), the use of the going concern basis of accounting will always be appropriate for public bodies. By definition, there also cannot be any uncertainty related to its use.

Public sector audit and going concern

26. The auditing framework in the public sector in respect of going concern currently reflects the different financial reporting framework.

27. Practice Note 10 is issued by the Public Audit Forum as a Statement of Recommended Practice and applies the requirements of auditing standards to the audit of financial statements in the public sector.

28. Its guidance on applying ISA (UK) 570 is that in most public bodies, the use of the going concern basis of accounting is straight-forward because the applicable financial reporting frameworks envisage that it will apply where the body's services will continue to be delivered by the public sector. Auditors can therefore conclude that a going concern basis of accounting is appropriate without detailed cashflow projections etc.

29. It is not expected that auditors will generally have to report any matter in the Independent Auditor's Report in respect of going concern, other than the standard wording required by ISA (UK) 570.

30. More work is appropriate where there is an intention by the government to discontinue a body's operations or transfer their functions outwith with the public sector (privatised).

31. If a body is to be discontinued, but its functions are to be transferred elsewhere in the public sector (eg, the body is merging with another existing body, or the functions are being transferred to another public body), the going concern basis of accounting is still expected to be appropriate.

32. For example, this was the case when NHS Argyll and Clyde was dissolved on 31 March 2006, and its assets, liabilities and the responsibility for delivering health services within its geographic boundaries were transferred to the successor boards, NHS Highland and NHS Greater Glasgow and Clyde.

33. If the body's functions are to be discontinued or privatised, auditors may seek confirmation from the sponsor department that the body continues to have financial backing to utilise its assets and meet liabilities as they fall due. If adequate confirmations are received, it is reasonable to conclude that the going concern basis is appropriate. If no such confirmation is provided, auditors may decide there is a material uncertainty to be disclosed.

Going concern and arm's-length external organisations

34. Arm's-length external organisations (ALEOs) are separate organisations used by public bodies to deliver services (eg, sport, leisure, museums and theatres). Although ALEOs are controlled or at least influenced by public bodies, they are not subject to the public sector accounting or auditing frameworks. ALEOs may however be included in the public body's group financial statements.

35. The auditor of an ALEO may report going concern issues. However, the going concern basis not being appropriate for an ALEO does not necessarily impact on the values of its assets and liabilities reflected in the group financial statements. For example, the auditors of the council establish what the arrangements are for discontinuing the ALEO. Where responsibility for delivering the service reverts back to the council, there may be an agreement that the assets and liabilities will transfer to the council at the same amount as they are carried in the ALEO's financial statements.

Financial sustainability

The relationship between going concern and financial sustainability

36. Financial sustainability as defined in the Code of Audit Practice is concerned with whether the public body has effective and appropriate arrangements in place to deliver its services in the medium and long term. The impact of Covid-19 could also threaten service delivery in the short term.

37. If a business in the private sector operates in a manner that is not financially sustainable, eventually it will be forced to cease to operate; it will stop being a going concern. The concepts are therefore inextricably linked.

38. Auditors in the private sector therefore generally do not distinguish financial sustainability from going concern. They report on going concern (encompassing financial sustainability) in the Independent Auditor’s Report.

39. The relationship between the concepts of going concern and financial sustainability is different in the public sector. This is a product of the continuity of the delivery of public services compared with entities in the private sector that may have to stop trading and be liquidated.

40. In the public sector, the government can intervene to increase funding or adopt a different delivery model. The services would only cease to be delivered if the government changed policy and decided to stop their delivery. There is always a reasonable lead time for such an event.

41. The financial sustainability of a body and the services it provides is nevertheless important in the public sector. It is likely to be of greater public interest than the application of the going concern basis of accounting.

42. Even in more routine times, cost pressures and reduced funding in real terms can cause financial stress and create risks to a public body’s financial sustainability. This has been exacerbated by the impact of Covid-19. However, this has no direct impact on the basis of accounting.

Audit reporting on financial sustainability in the public sector

43. The Code of Audit Practice requires auditors to conclude on the effectiveness and appropriateness of a body’s arrangements for financial sustainability as part of the wider scope of public audit.

44. Auditors report their conclusion in their Annual Audit Report. Even where there are serious weaknesses in a body’s arrangements and remedial action is required, it does not impact on the going concern basis of accounting. Auditors do not report matters concerned with financial sustainability in the Independent Auditor’s Report.

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