Sharman Secretariat
Financial Reporting Council
Aldwych House
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30 June 2011

Dear Sirs

Going concern and liquidity risks

ACCA (Association of Chartered Certified Accountants) is pleased to have this opportunity to provide evidence on the above subject in response to the call from the Sharman Inquiry.

We would like to comment on five areas and our remarks are directed principally to the case of listed companies.

Adequacy of information in IFRS and other sources to assess the going concern and liquidity risks (your questions 1 and 4)

Financial statements compliant with IFRS provide a great deal of information which should be relevant for investors and others to assess these matters. After all the objectives of general purpose financial statements in the Conceptual Framework of IFRS are that "existing and potential investors, lenders and other creditors need information to assess the prospects for future net cash inflows to an entity"(OB3).

The statement of financial position sets out at a point in time the overall financial position of an entity and is structured to show the approximate liquidity of the assets and the liabilities. The income statement provides the extent to which profits have been generated and the statement of cash flows indicates the extent to which the generation of profit has been translated into positive cash flows. The financial statements are largely made up of historical information and so of course when it comes to providing reassurance on the continuing existence of the reporting entity, have the inherent limitation of the extent to which the past trends will continue. However IFRS are clearly

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designed to mitigate this limitation for example with the separate presentation of discontinued activities and the disclosure of events after the reporting period. Also the value of users' assessments using historical data is much enhanced by the data being as up-to-date as practicable.

In terms of the measurement model IFRS are broadly a mixture of fair value and historical cost. Fair value should represent the immediately realisable value of assets which is helpful in a going concern assessment. Historical cost, because it is subject to impairment in IFRS, should represent at least the recoverable value of assets, though the asset values may be understated as compared to their realisation values. For financial assets stated at cost there is a requirement for the fair values also to be disclosed to help with this effect.

Users of IFRS financial statements should be able to assess the robustness of the capital of an entity by assessing the recognised values for the various assets and liabilities. However in addition entities are required to discuss their approach to capital and its management (IAS1.134-6). Arguably this could be extended to disclosing management's target levels of capital or the minimum capital requirements of prudential regulators.

In terms of liquidity IFRS7 includes comprehensive requirements on the contractual maturity of liabilities and how the entity manages the exposures. Any restrictions on the availability of cash need to be shown under IAS7. This standard also encourages the disclosure of the extent of undrawn facilities and arguably that might be made a requirement.

In terms of risk management there are extensive disclosures required by IFRS7 of financial assets and liabilities – both qualitative disclosures of the strategy for identifying and controlling risks as well as quantitative disclosures of the different risk exposures. It could be said that there are not equivalent disclosures for non-financial items in the standards. However in the voluntary Management Commentary practice statement there is such a recommendation, though perhaps this guidance is stated in very high-level terms with little specification of what might be covered. Requiring IFRS entities to comply with the Management Commentary practice statement and perhaps reviewing its level of specification are improvements that might be considered.

IFRS also specifically requires that the appropriateness of the going concern basis of preparation is considered (IAS1.25-26). There are provisions equivalent to the existing UK guidance for disclosures of material uncertainties about the going concern or where the going concern would not be appropriate. The key difference and weakness of IFRS in this area is that the minimum look-forward period is 12 months from the balance sheet date and not 12 months from the date of approval (as in the UK regime). This is all the more significant given that there is no maximum period in IFRS after the period-end for reporting.

In summary we consider that IFRS (with one exception) in their present form should currently provide opportunities for the significant relevant information to be provided to users to assess the going concern issue and liquidity risks. We make no comment on how well these requirements are in fact complied with in practice. Nor are we commenting on the timeliness of the financial statements in practice, beyond observing that it is a key factor here. There is a significant improvement to IFRS which should be made to extend the future period to be considered in the going concern assessment. We have noted above some other relevant aspects of the standards where improvements might be considered.

Three categories of entities for going concern disclosures (Question 9)

We consider that these remain the basis for the right approach in this area.

Some of the shortcomings that have been apparent in the recent crisis may have arisen from the failure to recognise there were material uncertainties regarding the going concern basis, or more probably from the failure to disclose them.

There is an understandable reluctance on the part of management to do so on the basis that the existence of material uncertainties will be considered by some as tantamount to the entity not being a going concern, triggering withdrawal of credit for example. In some cases the publication of financial statements may be delayed in order to try to resolve these uncertainties and avoid the disclosures.

We do not consider that providing different thresholds for disclosure (less than material uncertainties for example) is likely to be a helpful approach. It might be possible for management to be required to give the basis their decision in all cases, including those where the judgement is that the entity should be considered a going concern. There is, however, a risk here of boiler-plate statements which would provide little extra information about the degree of confidence in the going concern assessment.

It will sometimes be the case that management overstate the significance of the disclosure, as credit ratings and the market will probably have already factored in the possibility of default, whatever is shown in the financial statements. Empirical studies might help to demonstrate this. Vigorous enforcement against directors and auditors when they fail to make these disclosures may be more effective. Strengthening the policing of filing deadlines for financial statements or of the making of other announcements to the markets may also assist.

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Issues resulting in a heightened focus on going concern assessment (Question 10)

An assessment of going concern is integral to the preparation of financial statements and the audit of them. In both cases, the assessment will normally involve an estimate of the value of assets and liabilities (including contingent liabilities), cash flows and material risks to the business.

We consider that, in the recent past, issues underpinning the heightened focus on going concern will have included the following:

- the difficulty of making of fair value estimates of the value of assets and liabilities when the market for those assets has evaporated.

- the inability of entities, under accounting rules, to make provision for expected losses, with consequent implications for both the current going concern assessment and the reporting of the entity's position when these losses are realised.

- in the case of financial institutions, the significance for the going concern assessment of undertakings of financial support given by the Government.

- the uncertainty facing many businesses concerning the preparedness of lenders to support them, and the implications for entities of the conditions imposed by lenders for that continuing support.

- In the light of the prevailing economic conditions, the uncertainty of the effects for the entity, and its going concern status, of the solvency of its strategic suppliers and customers.

- the ability of auditors to make accurate judgements on the estimates made by directors/management.

- again, in respect of the work of auditors, the anticipated increase (apparently confirmed by research) in the level of fraud and deliberate mis-statement on the part of directors/management, especially with regard to the value of future cash flows.

Most of the above issues will have affected the going concern assessment even without the global financial crisis. But the various ramifications of the financial crisis will have influenced the dynamics of the going concern assessment and made the process more difficult for both preparers and auditors.

In respect of going concern, the most visible consequence of the bail out of the banks has probably been the re-emergence of the ‘expectation gap’: observers have asked what benefit the assessment can have if an entity can be classified as a going concern at the balance sheet date and yet have to declare very material levels of additional liabilities a short time later. The correct technical response to this question is that the going concern assessment has to take place in the light of the information which is available to preparers and auditors at that time and in accordance with the reporting rules which apply at that time. While the matters listed above may suggest areas in which enhancements could beneficially be made it is in principle unreasonable to expect preparers or auditors to do more than give their best estimate at the time of preparation and they cannot be expected to give a complete and ongoing assurance of the entity’s ability to withstand future shocks.

Audit issues (Question 11)

International Standards on Auditing (UK and Ireland) impose requirements relevant to

- the auditor’s approach to the assessment of going concern and liquidity risk
- the extent of the testing of companies’ processes and what other work is carried out
- any specific reporting on the going concern and liquidity risk to Audit Committees

Does the assessment of going concern involve different processes in certain industry sectors?

Yes, while the basic requirements are unaffected, risks affecting industry sectors differ and this necessitates different approaches to take into account the factors relevant to the assessment of going concern. For example, the retail industry may be particularly affected by a harsh economic climate as margins are eroded. In the construction sector, the availability of contracts and the necessary finance facilities may both be threatened.

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Are there different processes used where there is overseas reporting in addition to UK reporting?
Although the overseas reporting may be subject to different requirements to those in the UK and Ireland, in general, processes will be the same. In certain jurisdictions, national auditing standards have been less rigorous than International Standards on Auditing. For example the US Public Company Accounting Oversight Board standards only required a going concern assessment for a foreseeable future that was limited to 12 months from the date of the auditor's report. However in recent years, significant capital markets have converged to the international requirements.

Feed back on the guidance for directors of UK companies (Question 12)

We do not see the need for significant amendment of the existing FRC guidance.

If there are any matters arising from the above that require further clarification, please contact me.

Yours sincerely

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