



**BAKER TILLY**

Third Floor  
One London Square, Cross Lanes  
Guildford, GU1 1UN  
United Kingdom

T: +44 (0)844 2640300

[www.bakertilly.co.uk](http://www.bakertilly.co.uk)

Mr Marek Grabowski  
Director of Audit Policy  
Financial Reporting Council  
5th Floor  
Aldwych House  
71-91 Aldwych  
London WC2B 4HN

[hugh.morgan@bakertilly.co.uk](mailto:hugh.morgan@bakertilly.co.uk)

30 April 2013

Dear Marek

### **Implementing the Recommendations of the Sharman Panel**

Thank you for the opportunity to comment on the FRC's consultation paper "Implementing the Recommendations of the Sharman Panel: Revised Guidance on Going Concern and revised International Standards on Auditing (UK and Ireland)".

Our main concerns as well as the responses to the specific questions in the consultation papers are detailed below.

### **Main concerns**

Although we are supportive of the Sharman Panel Inquiry we have a number of concerns about how this is implemented in the FRC's proposed Guidance and have expressed these through our answers to the specific questions listed below. Our main concerns are summarised as follows:

1. High level of confidence – we do not believe the term "high level of confidence" is sufficiently understandable and could cause considerable confusion. In our opinion, it will result in companies being forced to disclose as material uncertainties matters that they previously would not have regarded as requiring disclosure but where they do not have the high level of confidence required by the Guidance.
2. Foreseeable future – although we agree with the distinction Sharman has made between short-term liquidity and more long-term solvency we do not believe that by extending the period considered as the foreseeable future beyond the short to medium term, to the cover both the economic cycle and the company's own business cycle, that directors will be able to have the high level of confidence that the Guidance requires. The further the period considered by directors is extended beyond the short to medium term the more uncertain directors will be over whether the risks they have identified will crystallise and how effective their



actions will be in addressing those risks and we believe that this will lead to significantly increased disclosure of material going concern uncertainties.

3. Implementation date – we do not agree that the Guidance should be implemented for financial periods beginning on or after 1 October 2012. This period has already started and to give directors time to assimilate the new requirements the implementation should be delayed for periods starting after the final Guidance is issued and would recommend implementation for periods beginning on or after 1 October 2013. In addition, if for any reason there was a short accounting period the Guidance could come out after the accounting period had ended making it very difficult for the directors to comply.
4. Application to SMEs –we do not agree with the approach taken to SMEs in the Guidance. The Guidance has clearly been written with large listed companies in mind with SMEs added almost as an afterthought. We recommend that the FRC consider the needs of SMEs first and follow the approach taken in the 2009 guidance to directors on going concern building the Guidance up from the bottom starting with the needs of SMEs.
5. Costs – in our opinion the proposed Guidance will have a number of costs. The impact of an extended period regarded as the foreseeable future and the requirement for the directors to have a high level of confidence will result in more material uncertainties being disclosed and referred to by the inclusion of emphasis of matter paragraphs in auditors' reports. This will not only have cost implications in terms of director and auditor time but will undermine confidence in UK businesses and make it harder and more costly for UK businesses to raise finance and transact with their suppliers.

### **Specific questions**

**Q1: Do you agree that the Guidance appropriately provides the clarification recommended by the Panel as to the purposes of the going concern assessment and reporting and is appropriate?**

NO

We do not believe that the Guidance provides the clarification recommended by the Panel as to the purposes of the going concern assessment and reporting or that it is appropriate.

**If not, why not, and what changes should be made to the Guidance?**

Whilst we are supportive of the recommendations made by the Sharman Inquiry we are concerned at the way the FRC is seeking to implement those recommendations and the impact that this will have on UK businesses. Our main concern with the Sharman implementation Guidance is that by requiring directors to obtain a high level of confidence and extending the period considered beyond what was commonly accepted as the foreseeable future this will make it difficult for directors to conclude there are no material uncertainties. In our opinion, if the new Guidance is followed



directors will find it difficult to obtain a high level of confidence about the entity's solvency and liquidity for the extended foreseeable future and this will require virtually all companies to disclose there are material uncertainties over the ability of the company to continue as a going concern, which will require the auditors to draw attention to those material uncertainties in their audit report. This increase in the disclosure of material uncertainties will be both confusing to investors and other users of accounts and could put UK companies at a competitive disadvantage when compared to companies in other markets.

We believe that a more appropriate starting point for the implementation of the Sharman recommendations would have been the FRC's 2009 guidance to directors on going concern and liquidity risk. This guidance came out at the height of the financial crisis at a time when directors needed guidance on their disclosure responsibilities and the guidance provided practical examples that directors could use when drafting their accounts. In our opinion, this was a very useful piece of guidance and very importantly it was aimed at the directors who are responsible for the preparation of the financial statements and considered the needs of small companies first. We recommend that the FRC redraft the Sharman implementation Guidance using the 2009 going concern guidance or directors as a starting point bearing in mind the importance of considering the needs of SMEs and that it is directors who primarily need the guidance on going concern not the auditors.

**Q2: Do you agree with the description in the Guidance of when a Company should be judged to be a going concern?**

NO

We do not agree that a company should only be judged as a going concern if, for the foreseeable future, there is a high level of confidence that it will have the necessary liquid resources to meet its liabilities as they fall due and will be able to sustain its business model, strategy and operations and remain solvent, including in the face of reasonably predictable internally or externally-generated shocks. Clearly such a business would have a very good chance of continuing as a going concern but we consider that such a definition raises the bar too high and virtually all companies will be unable to meet such stringent requirements.

Whilst we agree with the distinction that Sharman makes between short-term liquidity and longer term solvency in our experiences businesses fail when they cannot meet their liabilities as they fall due and whilst a business model might indicate the company is solvent in the long term it is short-term liquidity that will decide whether it survives. In our view the assessment of a company's ability to continue as a going concern should continue to require the directors to consider events in the short term, which is usually accepted as one year from approval of the financial statements, and it is inappropriate to extend the period beyond this short term. The longer the assessment period is extended into the foreseeable future the more uncertain the directors will be and the less likely it is that the directors will have a high level of confidence about those future events.





**Do you agree in particular that this should take full account of all actions (whether within or outside the normal course of business) that the board would consider taking and that would be available to it; and that, if the underlying risks were to crystallise, there should be a high level of confidence that these actions would be effective in addressing them?**

NO

As noted above we believe that the FRC's guidance in respect of the 'foreseeable future' is flawed. We do not believe that by extending the foreseeable future assessed by the directors beyond the short to medium term, to the cover both the economic cycle and the company's own business cycle, that directors will be able to obtain a high level of confidence about possible occurrences over such a long period or that, if the underlying risks were to crystallise, there would be a high level of confidence that the directors' actions would be effective in addressing them.

**Is the term 'a high level of confidence' sufficiently understandable? If not, why not, and how should the description or term be modified?**

NO

We do not believe that the term "a high level of confidence" is sufficiently understandable and will cause considerable confusion. Directors will be reluctant to reach the conclusion that they have a high level of confidence, auditors are more likely to disagree with that conclusion and investors will read the words "high level of confidence" and interpret it as a guarantee that the company is a going concern. In our view, a high level of confidence is too onerous a requirement and we do not believe that directors will be in a position to draw such a conclusion and will not want to put themselves in a position whereby they are virtually guaranteeing that the company will continue as a going concern.

Any company which has bank loans or overdrafts that are due for renewal in the new longer foreseeable future will in most cases be unable to obtain confirmation in advance from their bank that those facilities will be renewed and without that written assurance, even though the renewal may be outside the period normally considered by directors, we find it difficult to believe that directors will be able to conclude that they have a high level of confidence about their financing and will be forced to disclose this as a material uncertainty. SMEs are already finding that banks are very aggressive when it comes to renewing financing often demanding increases in interest rates and charging large arrangement fees. SMEs have also found that where they have taken out interest rate swaps they are often trapped into staying with the same bank because the cost of exiting the swaps is too onerous. Disclosure of material going concern uncertainties will mean that lenders are even more cautious in providing finance to SMEs and will protect themselves by charging higher rates, having tighter covenants and generally make it more difficult for an SME to get the funding that they require.

If SMEs do have to increase their disclosure of material going concern uncertainties this will be picked up by credit rating agencies and companies may find that suppliers



will not deal with them or demand payment upfront and generally make it harder for them to do business, becoming even more dependent on bank financing to enable them to continue trading.

**Q3: Do you agree with the approach the Guidance takes to the implications and nature of actions within or outside the normal course of business? Do you consider that the Guidance explains their nature sufficiently clearly? If not, why not and what changes should be made to the Guidance?**

NO

Although we considered that the Guidance on what is included within and outside the normal course of business was reasonably clear and it was helpful to have some examples presented in a table, we did not find it easy to understand how these concepts are to be used. If it is intended that actions within and outside the normal course of business are to be treated differently, the Guidance needs to make this much clearer otherwise the distinction should be dropped.

**Q4: Do you agree with the approach taken to interpreting the foreseeable future and is this sufficiently clear in the Guidance? If not, why not and how should the Guidance be changed?**

NO

See response to question 2 above. We do not agree with the approach taken to interpreting the foreseeable future.

**Q5: Do you agree that the use of the term ‘going concern’ in the phrase ‘going concern basis of accounting’ is sufficiently clearly distinguished in the Guidance from its use in the Code requirement for a statement that the company ‘is a going concern’ and from its use in the accounting and auditing standards in the context of material uncertainties about the company’s ‘ability to continue as a going concern’?**

NO

We do not find the use of the term “going concern” in the Guidance to be sufficiently clearly distinguished from other uses of the term going concern in other guidance and as a result it is confusing. This is demonstrated in paragraph 2.27 which states that “The corresponding threshold for departing from the going concern basis of accounting is a very high hurdle and may not be reached even when the company is not judged to be a going concern.” This would lead you to believe that a preparer could still prepare the accounts on a going concern basis even when they did not believe the company was a going concern. We recommend that the Guidance distinguishes itself from other requirements by using different terminology and not try to change existing accepted terminology.

**Is it clear from the Guidance that the statement the directors are required to make under the Code (that the Company is a going concern) should reflect the**



**board's judgement and is not intended to be absolute? If not, why not and what changes should be made to the Guidance or the Code requirement?**

NO

The Code requirement is for a statement that "the business is a going concern, with supporting assumptions or qualifications as necessary". It is not clear where the directors' judgement applies and that this is not intended to be absolute. In many cases this statement will be in a separate part of the annual report to the disclosure of going concern uncertainties with no clear linkage. If you combine the Code requirement for a statement that the business "is a going concern" with the Guidance requirement for "high level of confidence" this reinforces the readers view that going concern is guaranteed. The Code and Guidance need to be consistent with how going concern and material uncertainties are dealt with in Auditing Standards and not seek to reach the level of a guarantee that the business is a going concern.

**Q6: Do you agree that the judgemental approach in the Guidance to determining when there are material uncertainties to be disclosed is the appropriate interpretation of the relevant accounting standards?**

YES

We agree that a judgemental approach should be adopted for determining when there are material uncertainties to be disclosed however we do not agree with the Guidance's interpretation of this.

**Do you agree that the factors and circumstances highlighted respectively in paragraphs 2.30 and 2.31 are appropriate? If not, why not and what changes should be made to the Guidance?**

NO

We disagree with the factors and circumstances in paragraphs 2.30 and 2.31. Paragraph 2.31 attempts to provide a threshold for recognising a material uncertainty but does so using inappropriate criteria, an inappropriate timescale and the wrong qualitative probabilities.

These criteria are then overwritten by the statement, in 2.32, that there will always be material uncertainties to be disclosed whenever the board 'is unable to obtain a high level of confidence about the entity's solvency and liquidity for the foreseeable future'. We find it hard to envisage a situation where any board will be able to obtain such confidence, and this will lead to virtually every audit opinion including an emphasis of matter describing material uncertainties.

**Q7: Do you agree that the interpretations adopted in the Guidance in implementing Recommendation 2(b) are consistent with FRS 18 and ISA (UK and Ireland) 570? If not, why not and what changes should be made to the Guidance or those standards?**





NO

Recommendation 2(b) recommends that “the FRC should seek to clarify the accounting and stewardship purposes of the going concern assessment and disclosure process and the related thresholds for such disclosures and the descriptions of a going concern in the Code (and related guidance for directors and auditors) and in FRS 18 and ISA (UK & Ireland) 570, if possible in line with such international consensus”.

We do not agree that the interpretations adopted in the Guidance in implementing Recommendation 2(b) are consistent with those currently adopted in FRS 18 and ISA (UK and Ireland) 570. Furthermore, we do not believe that the FRC is in line with international consensus on going concern and the FRC appears to be taking unilateral action in the hope that by doing so the international consensus will follow. The IASB and IAASB are both working on going concern and we believe that the FRC should allow this to continue to a conclusion and seek to influence the outcome by working with the IASB and IAASB.

**Q8: Do you agree that Section 2 of the Guidance appropriately implements Recommendation 3?**

NO

For the reasons given below, we do not agree that Section 2 of the Guidance appropriately implements Recommendation 3.

**Do you agree with the approach to stress tests and the application of prudence in conducting them?**

NO

In our opinion, whilst they may be appropriate for larger entities, we believe that the reference in the Guidance to stress tests will be too onerous for directors of SMEs who will find it confusing and will ultimately be put off from doing the work intended. As noted above, the Guidance should be redrafted to take account of the needs of the directors of SMEs and not attempt to burden them with the responsibilities that are more appropriate to directors of large listed companies.

**Do you agree with the approach to identifying significant solvency and liquidity risks? Do you agree with the description of solvency and liquidity risks? If not, why not and what changes should be made to the Guidance?**

YES

We agree with the approach taken to identifying significant solvency and liquidity risks and the description of solvency and liquidity risks. Our concern is not with the description of solvency and liquidity risks but in how they will be interpreted in the context of the requirement for directors to obtain a high level of confidence over an extended foreseeable future.



**Q9: Do you agree that the approach taken in Section 4 of the Guidance in implementing the disclosures in Recommendation 4 is appropriate?**

NO

We do not agree that the approach taken in Section 4 of the Guidance in implementing the disclosures in Recommendation 4 is appropriate. We do not believe that the Guidance should impose any additional requirements beyond the existing statutory standard of care expected of directors within the Companies Act 2006.

**Is the term ‘robustness of the going concern assessment process and its outcome’ sufficiently clear?**

NO

In our opinion, this is not sufficiently clear and the introduction of another term such as “robustness” is unhelpful. Directors would need guidance as to what constitutes a robust going concern assessment before they can make such disclosures in the financial statements. A robust going concern assessment process in a well-run SME should have many of the same characteristics but would be fundamentally different to that considered appropriate in a larger listed organisation.

**Do you agree that the approach the board should adopt in obtaining assurance about these matters is appropriately reflected in Section 3 of the Guidance?**

NO

**Do you agree that the board should set out how it has interpreted the foreseeable future for the purposes of its assessment? If not, why not and what changes should be made to the Guidance?**

YES

We agree that if directors are required to have a high level of confidence about a longer foreseeable future it would be in the interests of both the directors and the readers of the financial statements if the directors set out in the going concern disclosures how they have interpreted the foreseeable future for the purposes of their assessment.

**Q10: Do you agree that the proposed amendments to the auditing standards appropriately implement the enhanced role of the auditor envisaged in Recommendations 4 and 5?**

NO

We do not agree that the proposed amendments to the auditing standards appropriately implement the enhanced role of the auditor envisaged in Recommendations 4 and 5.





We believe that the FRC should be working with international standard setters to develop guidance on going concern reporting and not unilaterally amending UK standards to introduce differences between UK and International auditing standards. We have long been supporters of the international consistency in auditing standards that the IAASB has been working towards and believe that the inconsistencies brought in by the FRC's proposals could not only result in UK businesses being put at a competitive disadvantage but would also result in additional work for UK auditors. The Sharman Panel recommended that the FRC seek international consensus among standard setters, regulators and all of their stakeholders before making changes to UK auditing standards and we do not believe that the FRC has done so in drafting the amendments to the auditing standards.

**If not, why not and what changes should be made to the auditing standards?**

Paragraph 17-2 of the proposed revisions to ISA (UK and Ireland) 570 requires the auditor to determine whether he has "anything" to add in relation to the directors' disclosures. We do not believe that there will be any situations where the auditor does not have "anything" to add, going concern is a highly complex and judgemental area and there will always be something that the auditor could add to the directors' disclosures. We would recommend that as a minimum the requirement be changed to "anything material to add" which would give the auditor some scope for applying their professional judgement.

Even if the requirement is amended to "anything material to add", it is unclear what this new language means and how it differs from the test for an emphasis of matter. This could rise to a problem of auditor's disclosing new material in the audit report that ought to be disclosed by the directors. An emphasis of matter merely draws the readers' attention to material uncertainties about going concern that the directors have described in their disclosure. Requiring the auditor to add to the directors' disclosure could be interpreted as meaning that the directors' disclosure about going concern was deficient in some respect and that the auditor was qualifying their report.

**Q11: Do you agree that it is appropriate for the Supplement to confirm that central bank support for a solvent and viable bank does not necessarily constitute a material uncertainty?**

YES

We agree that it is appropriate for the Supplement to confirm that central bank support for a solvent and viable bank does not necessarily constitute a material uncertainty.

**In particular, do you agree that central bank support (including under ELA) may be regarded as in the normal course of business where the bank is judged to be solvent and viable?**

NO



Whilst we are supportive of the role that banks have in the economy it does not exempt them from disclosure of going concern uncertainties and they should be held to at least the same standard of reporting as other companies.

**Do you agree that the approach set out in the Supplement to assessing whether there is a material uncertainty is appropriate and consistent with the general approach in the Guidance? If not, why not and what changes should be made to the Supplement to the Guidance?**

NO

We do not agree that the approach set out in the Supplement to assessing whether there is a material uncertainty is appropriate and consistent with the general approach in the Guidance. The Guidance for non-banks establishes a threshold of “high level of confidence” over an extended foreseeable future and we believe this will result in the disclosure of far more material uncertainties than were required to be disclosed under the previous guidance. This is an inevitable consequence of how Sharman has been interpreted and although we consider the Guidance goes too far we do agree there needs to be more disclosure of going concern uncertainties.

The Supplement for banks is inconsistent with the Guidance for non-banks because it could lead to situations where a bank that is reliant on central bank support in order to continue as a going concern in the short term does not make disclosure of this uncertainty in its financial statements. This central bank support may be only required in the short term and the bank’s business model may show them to be solvent in the longer term but in any non-bank situation reliance on short term funding would as a minimum be regarded as an uncertainty that would be disclosed and in some circumstances could be interpreted as a material uncertainty. Both the Code and the Listing Rules require a statement that the business is a going concern together with supporting assumptions and it might be expected that a where a bank is reliant on central bank support this is regarded as a supporting assumption that should be disclosed.

**Q12: Do you consider the proposed implementation date to be appropriate? If not, why not and what date should the application date be?**

NO

We do not consider that the proposed implementation date is appropriate. We have a number of reservations about the Guidance which we feel should result in some major revisions but, even if the Guidance were in close to final form, there would still be insufficient time to apply it to financial periods beginning on or after 1 October 2012 which would effectively cover interim periods ending in June 2013 and September 2013 year-ends, and short accounting periods.

It is important to recognise that this Guidance will be used by directors in making their going concern assessment and drafting going concern disclosures. It is important that directors of all sizes of business are given sufficient time to understand and plan for implementation of the Guidance. The proposed implementation date





means that directors are already in the period affected by the Guidance and should be making going concern assessments following the criteria in the Guidance.

We recommend that the implementation date be delayed so that directors have sufficient time to absorb the requirements of the Guidance and plan for its implementation. As a minimum we suggest that the implementation date be delayed so that the start of the first period under consideration is after the date of issue of the Guidance. We would recommend if the Guidance is issued in June or July 2013 that the implementation date be changed to financial periods beginning on or after 1 October 2013.

**Q13: Do you believe that the Guidance will deliver the intended benefits?**

NO

We do not believe the Guidance will deliver the intended benefits.

**If not, why not? Do you believe that the Guidance will give rise to additional costs or any inappropriate consequences? For example, as compared with the 2009 Guidance, do you believe that the Guidance will give rise to fewer companies being judged to be a going concern and/or more companies disclosing material uncertainties? If so, what are the key drivers and can you give an estimate or indication of the likely cost or impact? Do you believe that such additional costs or impact would be justified by the benefits?**

In comparison to the 2009 Guidance, we believe that the proposed Guidance will give rise to many more companies disclosing material going concern uncertainties and auditors drawing attention to those material uncertainties through the use of emphasis of matter paragraphs. Whilst we do not believe that there will be many more going concern qualifications, the impact on business confidence will be enormous and place UK companies at a competitive disadvantage when it comes to raising finance or doing business both at home but particularly overseas.

We have not performed a cost benefit analysis but would recommend that the FRC does perform a cost benefit analysis before introducing such fundamental changes. In our opinion there are a number of aspects to the costs involved. There will be cost implications in the time and effort that directors and auditors will put into preparing, reviewing and agreeing enhanced going concern disclosures. This will often be the most senior individuals and both the client and auditor and unless the disclosures are straightforward will involve a lot of consideration and potentially involve legal advice.

UK companies that make these enhanced going concern disclosures and report more material uncertainties will find it difficult to renew or raise additional financing and will have to pay more when they do so. Credit rating agencies will take notice of the going concern disclosures and suppliers may withdraw extended credit to SMEs and ask for payment upfront. All of these are real costs to UK businesses and puts them at a disadvantage when compared to their overseas competitors.





**Q14: Do you agree with the approach to SMEs in the Guidance? If not, why not and what changes should be made to the Guidance?**

NO

We do not agree with the approach to SMEs in the Guidance. The Guidance appears to require SMEs to follow the requirements for larger and listed companies in full and, as stated above, we think the FRC should “think small first” and start by considering the needs of SMEs and then add on the additional considerations required for larger and listed companies. We recommend that the FRC should use the 2009 guidance as a starting point and build the Sharman recommendations into that guidance rather than start again with guidance developed primarily for listed companies.

**Q15: Are there any other matters which the FRC should consider in relation to the Guidance and the Supplement? If so, what are they and what changes, if any, should be made to address them?**

We recommend that the FRC follows the layout of the 2009 guidance and clearly distinguishes which parts of the guidance are relevant to each type of company. The use of a table in paragraph 14 of section 2 to illustrate what is within and outside the normal scope is very useful and we recommend that the FRC considers the use of more tables and examples to illustrate the concepts in this Guidance. Our concern is that this Guidance is primarily for directors and because it is complicated and difficult to follow and a change from the 2009 guidance directors will need help in implementing the requirements and guidance on the level of disclosure considered acceptable. We accept that the FRC is sensitive to concerns over “boiler-plate” but we believe that this is too important a piece of guidance to issue without examples.

Please contact me should you wish to discuss any of the points raised in this response.

Yours sincerely

Hugh Morgan  
Technical Director  
Baker Tilly UK Audit LLP