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Our ref gf/815

29th April 2013

Dear Mr Grabowski

Implementing the Recommendations of the Sharman Panel

On behalf of KPMG in the UK, I am responding to the FRC's consultation, "Implementing the recommendations of the Sharman Panel".

We see the FRC's proposals as capable of producing better business model reporting that provides the shareholders with information about both the longer term risks and the shorter terms shocks that the company's strategy entails and the company's approach to managing them. Such reporting would deal with the forward-looking financial/ economic viability of the business model and we welcome that.

In our response to the Sharman Panel's Preliminary Report we stressed the need to distinguish this forward-looking information about financial/ economic viability of the business model (the stewardship purpose), from the question of the basis of accounting and accounts disclosures (the financial reporting purpose). We observed that if such a distinction were not made there would be a risk that readers mistakenly associate potential adverse developments within the business model look-forward period with uncertainty about the company's more immediate prospects.

Based on our reading of the proposals we are concerned that this distinction has not been made and the longer term narrative reporting has also been positioned as the basis for the Listing Rules statement on going concern and for the identification of "material uncertainty" for financial reporting (and since both of these elements are placed in the context of "going concern, we believe that this in itself will perpetuate confusion and, if anything, increase the expectation gap).

This issue is further exacerbated by the high hurdle for the "going concern" test set by the new definition ("*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 predicable internally or* *externally generated shock*") and the extension of the "foreseeable future" period of assessment potentially to include the entire economic cycle.

Accordingly, we are concerned that as drafted the proposals mean that almost no company would be able to meet the test on a "clean" basis for the purpose of the Listing Rules or be able to conclude there is no "material uncertainty" as regards going concern for financial reporting purposes. We think this would be a very unfortunate development, which would add confusion rather than greater clarity to corporate reporting.

These concerns would be addressed if the narrative disclosures were unambiguously disclosures about the risks to the longer term viability of the business model and not about more immediate "going concern" issues. This would then leave the words "going concern" as only being defined once, for the purposes of the basis of preparation of the accounts, rather than twice, in different ways, as is proposed in the guidance; and it would facilitate moving the material uncertainty threshold somewhat without going to the extremes we believe is indicated by the current proposal.

As regards banks, the key message in the proposals, with which we agree, is that reliance on central bank liquidity facilities might fall within the normal course of business of a bank, and so might not indicate a material uncertainty. However, on the basis of the main text of the draft guidance and the particular tests in the Supplement, it is difficult to see how a bank could avoid a material uncertainty.

Whilst we agree that material uncertainty reporting should be the same for all companies, albeit not on the model proposed by the draft guidance, we are concerned that the costs of imposing the process on unlisted or unquoted companies have not been assessed.

In Appendix A to this letter we have set out more fully the concerns summarised above in relation to the use of the Listing Rules going concern statement and material uncertainty disclosure. In Appendices B and C we have set out other comments and our answers to the particular questions that the FRC has asked. Please do not hesitate to contact either Mike Metcalf (on 020 7694 8081) or me should you wish to discuss further any aspect of our response.

Yours sincerely

Tony Cates.

Tony Cates
Head of Audit

Appendix A: Our views

Changing the corporate reporting model

A gap that needs to be filled

1. We agree with the FRC that corporate reporting needs to change. At present we have one objective of reporting in this area: a going concern assessment, of the company's position and prospects, to inform the decision to use the going concern basis of accounting and the disclosure of any material uncertainties in relation to that decision. This is what the FRC has called the financial reporting purpose. Today this accounting decision is (in effect) explicitly stated, under the existing FRC guidance, as the LR 9.8.6R (3) statement that the company is a going concern, with any material uncertainties being given or referred to as supporting assumptions or qualifications.

2. We agree with the Sharman Report and with the FRC that, first, the existing going concern assessment does not have enough focus on solvency and, second and fundamentally, that the existing *reporting model* leaves a significant gap. The gap is primarily that shareholders want and deserve better information about the much longer term future prospects. This is about looking into the more distant future and assessing the possible opportunities and threats for the business model, and how the opportunities might be capitalised upon and how the threats might be managed or contained. We also agree with the FRC that any new reporting, to meet this objective, should be of "better not more" information. We particularly agree that excessive cross-referencing should not be used in such a disclosure; part of the problem of current corporate reporting is that material can be distributed around the report and is in need of pulling together, with emphasis, in one place (and meeting that need might also help to focus the mind on whether the information, when seen together, has any omissions). This reporting is what the FRC has termed the stewardship purpose.

3. In addition to this significant gap, we agree that the threshold for material uncertainty disclosure could benefit from being moved, albeit not in any extreme way.

4. We agree, therefore, that going forward there should be two reporting objectives to a company's assessments of its position and prospects, with the first being new and filling the significant gap and the second requiring some clarification and revision:

- to drive narrative reporting about the prospects, into the long term, of the company and its business model – referred to in the draft Guidance as the stewardship or business model purpose; and

- to inform the decision to use the going concern basis and to disclose any material uncertainties that may invalidate that decision in the foreseeable future – referred to in the draft Guidance as the financial reporting purpose.

"Going concern" mis-used to fill the gap

5. However, we do not believe that the filling of this "stewardship" gap can reasonably be termed going concern reporting nor do we agree that the stewardship assessment should form the basis of a conclusion as whether there is a material uncertainty as to the entity continuing to be a going concern.

6. The consequences of the FRC's proposals would be significant – in that we believe the proposed tests to be unachievable by nearly all companies. In the remainder of this appendix we explain why we are strongly of the view that the proposals as they stand are unachievable (paragraphs 8-23), how these concerns might be addressed (paragraphs 24-34), followed by a number of other points about the proposals for audit, for banks and for implementation timing (paragraphs 35-45).

7. It may be, of course, that our concerns are based on a misunderstanding of the draft guidance. If that were so then the draft would still be in need of significant revision and clarification (and potentially further consultation).

Why are the tests unachievable?

Listing Rules narrative reporting

8. The draft guidance states that a company is judged to be 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" (section 1 paragraph 12).

9. This appears to be a very high hurdle. There are three factors contributing to this:

- A high level of confidence is required.
- It is required over the foreseeable future, itself redefined as the long-term (discussed further in paragraphs 12-13 below and Appendix B).
- A high level of confidence is required not only as to survival (avoiding insolvency) but that the business model can be sustained, meaning, we infer, that it can provide a long-term economic return in excess of the cost of capital (per footnote 4).

10. Any one of these alone would be a significant raising of the bar, but all three together seem unachievable for nearly all companies. For example, in a pharmaceutical company drug patents have a finite life. Developing/ bringing new drugs to market depends on an uncertain ability to innovate continuously, control of the significant expense involved so as to be able to make an economic return, and it depends on third parties (regulatory approval).

11. Furthermore, whilst it is right for narrative reporting to look further into the future and disclose what may be, in that longer-term future, an issue for profitable survival, such issues clearly are of a more speculative nature, and that speculation does not seem to be a reliable or common-sense basis for "labelling" a company as "not a going concern" – it would move reporting to the opposite end of the scale from where it is today. Labelling companies in that way is not intuitive, and also seems likely not only to make it difficult for companies to accept and hence implement as intended, but also to lead to misunderstandings among users of annual reports. We believe that this is likely to reinforce expectation gaps. It may also have regulatory effects, such as raising questions about the ability ever to make a clean working capital statement in a prospectus.

Foreseeable future in particular

12. In the context of the stewardship objective, we are concerned that there is insufficient clarity as to the meaning of "foreseeable future". We believe that the intended meaning is the economic cycle. This is supported by the usage within section 1 paragraph 14(b), section 2 paragraph 2 and Appendix 1 paragraph 12 although, as explained in our Appendix B, other material in the draft guidance is not necessarily consistent with that or with each other. The lack of clarity over what constitutes the foreseeable future seems to be a recipe for uncertainty of application and a gap between directors' assessments and what users expect directors actually to have done.

13. As we note above, taking the draft guidance as a whole, we believe that the intended meaning of "foreseeable future" is the general economic cycle. That is a long period, though it might be debated as to exactly how long it is. Whilst it is right to look into that sort of distance in order to identify what should be covered in the narrative reporting, making such a period part of the test of a going concern is a major contributor to that test being unachievable. Furthermore, given that matters cannot be reliably <u>foreseen</u> over such a period, and are more in the nature of considered speculation, it is counter-intuitive to label this period as the "foreseeable future".

Financial reporting – material uncertainty disclosure in the accounts

14. We agree that the threshold for departing from the going concern basis of accounting should remain the very high hurdle, *viz* that accounts should be prepared on a going concern basis unless there is no realistic alternative to liquidation or cessation of trading.

15. However, we disagree with the way in which the proposals would radically change material uncertainty disclosure. They would convert it into a version of the narrative reporting, employing similarly unachievable tests.

16. In our view material uncertainty disclosure is, today, an accounts disclosure, ie one aimed at contributing to a true and fair view, *about an accounting judgment*. It's about whether there are uncertainties that make it a foreseeable possibility that the decision to use

the going concern accounting basis might no longer hold true. By "foreseeable", we refer to a look-forward of at least twelve months forward from the accounts' approval. Whilst we believe that this remains basically the correct approach, within that approach we should very much welcome more guidance on the appropriate threshold for material uncertainty disclosure. This would bring increased focus from boards and an increase – albeit not a dramatic one – in the number of such disclosures. We consider how that might be done at paragraphs 24-34.

17. The draft guidance addresses material uncertainty disclosure in three ways: a purpose (section 2 paragraph 29), a disclosure threshold (paragraph 31) and outcomes in relation to narrative reporting (paragraphs 32-33). It is unhelpful to have multiple statements of the basis of the disclosure. Furthermore, though different in detail they are all consistent with a radical shift to become part of narrative reporting of the business model.

18. The effect of the draft guidance appears to make the basis of material uncertainty disclosure tag along with the narrative reporting of long-term business model (financial/ economic viability) and make it effectively synonymous with that. We do not welcome that outcome. In particular, the shift proposed would see a material uncertainty in the accounts of every company that cannot make an unqualified narrative reporting going concern statement –This would bring about the result that the 2008/09 update/ revisions to the guidance rightly sought to avoid. It would "devalue the currency" of material uncertainty and in so doing present less useful information to investors. It could also prevent companies from raising capital in the equity markets, as the UKLA usually requires that there be no material uncertainty/ auditor's emphasis of matter.

Proposed purpose of material uncertainty disclosure

19. Although section 1 paragraphs 4 and 6 make the ostensible purpose of disclosure the giving of a true and fair view, we find the substance of section 2 paragraph 29's stated purpose to be more consistent with narrative reporting: it is to disclose the ability to continue as a going concern, as defined in the draft guidance to serve a narrative reporting purpose, for the benefit of users' economic decision-making; we find this indistinguishable from a narrative reporting purpose.

Proposed threshold for material uncertainty disclosure

20. The threshold requires one to look out over the "foreseeable future", presumably as defined in the guidance, for the narrative reporting, being seemingly the general economic cycle.

21. It is also unclear where exactly the bar has been set. Paragraph 31(a) makes it clear that it is met if there is more than an evens chance that, over that foreseeable future, the company will suffer severe economic/ financial distress for which there is no realistic alternative but to take action outside the normal course of business and that there is not high

confidence that such actions will be highly likely to be effective. Paragraph 31(b) equally makes it clear that it will not be met if the chances of this are remote. In between these two extremes companies and auditors are invited to use judgement, but without any indication as to where they should draw the line. This is likely to lead either to a drift to one end of the spectrum or the other or inconsistency in application. We do not regard this as helpful.

22. So this test does not look at the possibility of failure of the company but just of distress. Again that feels more consistent with narrative reporting about the business model.

Stated outcome of applying the purpose/ threshold

23. As if to prove the point, paragraph 32 states an outcome in clear terms: for a company that is "unable to obtain a high level of confidence about the entity's solvency and liquidity for the foreseeable future but the going concern [accounting] basis is appropriate, there will be material uncertainties to disclose." Effectively a material uncertainty would become largely synonymous with a narrative reporting *qualified* going concern, making material uncertainty practically redundant as a concept.

How might the issues be addressed?

Narrative reporting

24. As we noted above, under the proposals it appears that the going concern statement required by the Listing Rules is being re-purposed to force the "stewardship" disclosures. We do not believe that creating an unachievable "going concern" test, as a mechanism to require additional disclosure of the directors' view of the longer-term risks and uncertainties that may threaten the company's survival, is a satisfactory way forward.

25. In our view, it would be better to put in place such a disclosure requirement *directly* rather than in the indirect fashion proposed. There are already the following two disclosure requirements in this area:

- "The directors should include in the annual report an explanation of the basis on which the company generates or preserves value over the longer term (the business model) and the strategy for delivering the objectives of the company" (Code Provision C.1.2).

- "In the case of a quoted company the business review must, to the extent necessary for an understanding of the development, performance or position of the company's business, include— (a) the main trends and factors likely to affect the future development, performance and position of the company's business" (s417(5) Companies Act 2006).

26. In October 2012 BIS issued draft regulations to revise narrative reporting, which would replace the last mentioned with the following:

- "In the case of a quoted company the strategic report must, to the extent necessary for an understanding of the development, performance or position of the company's business, include— (a) a description of the company's strategy, (b) a description of the company's business model, (c) the main trends and factors likely to affect the future development, performance and position of the company's business" (proposed s414C(4)).

27. The narrative reporting aimed at by the FRC's draft guidance would be consistent with these forward-looking requirements, particularly the proposed s414C. The FRC's reporting would give much needed emphasis, however, to risks – things that could possibly happen although they cannot necessarily be foreseen today – that the business model cannot survive in the long term. Whilst this is implicit in, eg, s.414C(4), this negative aspect of future developments etc could be all too easily overlooked without further guidance. So we think that it would be more appropriate to acknowledge that the FRC's proposals are really draft guidance supporting these "headline" narrative reporting requirements – drawing out the key point about potentially fatal risks – than to continuing to use the Listing Rules going concern disclosure as a stand-in as if there were no such narrative reporting requirements.

28. Recognition that this is really business model reporting would not prevent the introduction of auditor reporting along the lines envisaged by these proposals. We return to this at paragraphs 35-38.

Material uncertainty disclosure

29. Although we have major objections to the way in which the draft guidance would radically change the basis/ nature and number of material uncertainty disclosures, we recognise that there is a need to move current practice including that, without changing the fundamentals, this may bring more companies, but not excessive numbers, within the net of material uncertainties. This is also linked to the IASB's forthcoming consultation on amendments to IAS 1.

30. The FRC and the IASB discussions to date address the case where the company needs to take action outside the normal course of business. We agree with the IAS 1 proposal put to the IASB that this is a warning sign that there is or may be a material uncertainty, rather than its being the test or definition of a material uncertainty itself. We also note that the IAS 1 proposal recognised that material uncertainty disclosure is about an accounting judgment. We agree.

31. We think, however, that the IASB's discussion has yet to follow this through by articulating sufficiently clearly the material uncertainty test itself. So there is room for the FRC to promote and crystallise UK opinion on this. It seems to us that the starting point for that debate would be to consult on a test along the following lines:

- A material uncertainty exists when there is a [ ] chance that the company has no realistic alternative to liquidation or ceasing to trade in the foreseeable future .

32. This would need to be supported by material amplifying "foreseeable" and suitably filling in the blank in, "[ ] chance". To take the first, the existing UK consensus (already beyond IAS 1) is for a minimum of twelve months from the approval of the accounts, and that remains right, as a minimum. However, the debate should be about whether the emphasis should be on exactly what it says, ie what directors ought reasonably to foresee. At the same time, it could be stressed that at some point in the future one cannot meaningfully assess the chances of events – past that point views about the future are speculation and not "foreseeable".

33. In terms of filling in the blank in, "[ ] chance", this is a question of a qualitative probability test, ie debating whether it is, say, more than an insignificant chance, a possible chance, a meaningful probability, or more likely than not (although we think this one would bring too few companies within material uncertainty)

34. We appreciate that the discussion set out above is not definitive at this stage. However, we trust that it does illustrate that, without changing the fundamentals of the current approach to material uncertainty, there is scope for improvement and for more companies, but not extreme numbers, to disclose material uncertainties. These are the sorts of issues that, in our view, need to be debated.

Audit reporting

On narrative reporting

35. Although we believe that the proposed disclosures by companies should not be labelled as a going concern assessment and conclusion, we agree that the substance of the intended narrative reporting could be covered by the audit report on the basis suggested by the FRC, ie negative assurance based on knowledge acquired in the course of the audit of the accounts.

36. On the assumption that the company's disclosures were reframed by the FRC as business model narrative reporting rather than going concern, then the requirement for auditors would need to be reframed. The proposals for ISA (UK & Ir) 570 paragraphs 17-2, 17-3 and ISA (UK & Ir) 700 paragraph 22C are based on "going concern". Instead, what would be required would be a more specific version of ISA (UK & Ir) 700 paragraph 22B(a), which deals with the annual report's being fair, balanced and understandable and providing all the information necessary for an assessment of performance business model and strategy. The precise words would need to be framed in the light of the precise words chosen for a reframed narrative reporting requirement for companies. Indeed it may be that all that would be required would be some suitable modification to paragraph 22B(a) (and the corresponding Code requirement).

37. If the disclosure were not reframed as envisaged above but left substantially unchanged then the following issues arise: first, a question of how the ISA(UK & Ir) 700 paragraph 22C reporting test differs from an emphasis-of-matter; second, the lack of clarity, in ISAs (UK & Ir) 260 and 570, as to the scope of the review of the basis of the company's narrative reporting (they reflect that one is done but are not clear that it is for the purposes of the audit *of the accounts*); third, why ISA (UK & Ir) 700's proposed test of "anything to add", is not "anything *material* to add", and why/ how it differs from the reporting test devised for paragraph 22B. It would, however, still require APB Bulletin 2008/10 to be reconsidered.

38. More generally, however, the confusion we refer to above as a result of the two different going concern purposes and the lack of a clear distinction between front end and accounts reporting on going concern may also make it difficult for constituents to understand with any clarity the extent and scope of the auditor's responsibilities in this regard, thus potentially increasing the "expectation gap" which currently exists.

Emphasis of matter

39. If the narrative reporting intended by the FRC is reframed as business model narrative reporting, and material uncertainty disclosure continues (in its fundamentals) as it is today – disclosure about an accounting judgment – then ISA (UK & Ir) 570 would not need to change from where it stands today.

40. We note that whilst the FRC has, as explained above, proposed a fundamental change in direction for a company's material uncertainty disclosure, it has not proposed any changes in relation to emphasis of matter in ISA (UK & Ir) 570. That standard seems clear that an auditor's emphasis of matter is about the accounting; its paragraphs 17 and 18 refer to disclosure necessary for a true and fair view (or to ensure that the accounts are not misleading) and disclosure of the possible inability to realise assets and discharge liabilities in the normal course of business. This seems directed at a user's understanding of the financial position set out in the accounts. This is different from material uncertainty disclosure as proposed by the FRC, which would be *de facto* business model narrative reporting.

Banks

41. Whilst the supplement for banks addresses in the main the prudential regulatory framework (not really the role of the guidance), the key passage is its paragraphs 53-59. The essential message is that reliance on central bank liquidity facilities might fall within the normal course of business of a bank, and so might not indicate a material uncertainty.

42. We agree with that key point, based on the current concept of material uncertainty. However, we find it difficult to see that the same proposition must necessarily hold true under the concept of a material uncertainty as the FRC proposes to remodel it. Put simply,

as we explain above, nearly all companies, including banks, would be unable to make an unqualified going concern statement; nearly all such companies, including banks, would also have material uncertainties to disclose. This flows not only from the specific connection made by the draft guidance between a qualified narrative reporting going concern and material uncertainty, but also from the high hurdle set as the threshold for material uncertainty disclosure.

43. Furthermore, for banks the particular conditions that would need to be met (paragraphs 53-59 of the supplement) appear unachievable (and somewhat internally inconsistent):

- "The board should have a high level of confidence that, if needed, those facilities will be accessible by the bank to a sufficient extent and over a sufficient time period to enable them to conclude that the bank will remain a going concern for the foreseeable future."

- "The board should have a high level of confidence that, if needed ... there is a credible path to repayment without resorting to action outside the normal course of business to realise its asset or discharge its liabilities."

- "The directors and auditors should seek to understand how the Bank of England would assess the solvency and viability of the bank and the credibility of the bank's plans to reach a point where access is no longer required. Without a sufficient understanding of this, the board may be unable to obtain a high level of confidence."

Given the definition of "foreseeable future", it does not seem possible to be able to have a high level of confidence on these issues. Furthermore, the role of the prudential regulators can be critical here and in this respect prudential regulators tend, quite understandably, to be more definitive about the short term than the long term. In our experience, prudential regulators are reluctant to give any indications beyond the short term. This is not because they are uncooperative, but simply because they recognise that the future is an unknown quantity.

44. So whilst we agree that reliance on such liquidity facilities ought not necessarily to give rise to a material uncertainty, on the basis of the main text of the draft guidance and the particular tests in the supplement, it is difficult to see how a bank could avoid a material uncertainty. As a lesser point in relation to banks, it is not obvious (at paragraph 75) why a top and emerging risk would not be a significant solvency or liquidity risk, nor why such a risk (how it was addressed) should be reported only "if appropriate". Section 4 paragraphs 1, 8 do not employ the language of "if appropriate".

Implementation date

45. As we have explained above, we have significant concerns that, in their current form, the proposals should not be implemented. In our view the proposals need to be reconsidered and another round of consultation be held. Clearly that will take us beyond the target of years commencing on or after 1 October 2012.

Appendix B – Other comments

46. In this appendix we set out a number of other comments, some of which would fall away if the proposals were reframed as we have suggested, and others of which would still remain to be addressed.

High level of confidence – message not clear enough

47. The draft does not define a "high level of confidence". We agree that it cannot be defined with any precision. However, we foresee that it will be a matter of argument in practice. Clearly it does not mean certainty. On the one hand, however, it might be something not significantly different from that. On the other hand, some, perhaps motivated by the stigma of not being able to make an unqualified statement of going concern, may see room for other views.

48. We also note that the draft definition is clear that a high level of confidence is required in relation to possible events during the whole foreseeable future. At the same time, other material might be read (or mis-read?) as requiring high confidence only in relation to the minimum (twelve months) period (section 2 paragraph 20, appendix 1 paragraph 3).

Foreseeable future – some inconsistencies

49. As we noted earlier, we believe that the "foreseeable future" is intended as the economic cycle, per section 1 paragraph 14(b). However, section 2 paragraphs 19-22, quoted below and accompanied by our observations, are not necessarily consistent with that or with each other:

- "... what the board knows or should reasonably be expected to know about the future."
  - What if the board concludes that it is not reasonable for it to know about what might happen over the general economic cycle?
- "... knowledge about the future ... reflects the expertise and experience of those making the evaluations".
  - This speaks only to what the board knows, not what it ought to know.
- "Boards address longer periods through the general economic and specific business cycles."
  - Which one applies? The general economic or the specific business cycle?

- "The length of the period considered is a matter of judgement and will depend on the nature of the company's business, its business cycles ...".
  - This does not seem consistent with the general economic cycle.
- "The length of the period considered is a matter of judgement and will depend on ... the life cycles of its assets ...".
  - This does not seem consistent with the general economic cycle, or necessarily with business cycles (assets cycles could be shorter).
- "The length of the period considered is a matter of judgement and will depend on ... the quality of the data available."
  - Does this mean that if there is no quality data available about the company's prospects over the general economic cycle, then the company is absolved from the need to look out that far?
- "The appropriate periods for this purpose should in principle be consistent with those appropriate for effective business planning and management."
  - Few companies plan over the general economic cycle. Is this absolving companies from the need to look out that far?

50. Appendix 1 paragraphs 5 and 6 do not clarify matters either:

- "The quality of what the board knows about the future ... exercising the standard of care generally applicable to directors in the exercise of their duties."
  - The general duty of care, skill and diligence[1] is, essentially, a matter of what the director should reasonably be expected to know or such greater knowledge as he actually has. So, once again, is it legitimate for the board to conclude that it is not reasonable for it to know about what might happen over the general economic cycle?
- "This is a matter for judgment, having regard to ... the board's determination of the residual liquidity and solvency risks that it will tolerate."
  - Does this mean that a board that is prepared to let its company tolerate more risk need therefore look out less far than others?

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1 See s174 Companies Act 2006.

51. We also note that the reporting required of directors includes what they have interpreted as the foreseeable future (section 4 paragraphs 1, 8), perhaps encouraging the idea that the interpretation is of more than the length of the general economic cycle.

Solvency – more clarity needed outside the financial sector

52. Whilst liquidity is well understood we believe that the FRC's intentions in relation to solvency and financial and economic distress would be less well understood. First, all failed companies are termed "insolvent", even though virtually every such case is a result of a liquidity failure. Petitions for wind-up of companies on the so-called balance sheet test, as opposed to the so-called cash flow test, are almost unheard of.

53. Second, the draft guidance does not include any practical guidance as to how to assess future solvency. Banks, of course, are accustomed to doing this. The main text, however, appears short on substance for other companies (appendix 1 paragraphs 11, 12, 21, 22), and only the footnotes hint that solvency is a balance sheet matter (footnotes 4, 30). What the footnotes are hinting at is that the analysis is about today's balance sheet position and expectations of future profitability. (Therefore, contrary to appendix 1 paragraphs 14 and 15, a solvency issue would almost always be an example of economic distress.) Could the draft deliver that message more easily and clearly?

54. Again, however, there is a conflict with the insolvency law balance sheet test, which is that the value of the assets falls below the amount of the liabilities[2]. The draft seems to be asking for a margin (excess assets) to be maintained *at all times*, whereas the purpose of a margin is to be used up, ie absorb future problems.

Other practical matters – more needed

55. The 2008/2009 revisions (2009 Guidance) contain practical information for directors about making the assessment. It may be limited to liquidity, but, nevertheless, it is helpful. There is no equivalent material in this draft guidance.

56. Furthermore, paragraphs 15, 16 of the 2009 Guidance made clear that certain situations, which were commonplace at the time (and have not yet become rare again), did not give rise to material uncertainties. This was the critical element of those earlier updates that achieved the FRC's principal aim at the time, *viz* not unnecessarily to have widespread material uncertainties/ emphases of matter. There is no consideration of such matters in this draft guidance.

57. Paragraph 66 of the 2009 Guidance also usefully pointed out to directors the need to include the particular words, "material uncertainty that may cast significant doubt …", in

[2] Note that footnote 30 considers the market value of the liabilities, which, at a troubled company, must inevitably fall to be equal to the assets' value.

their accounts disclosures (in the case of such uncertainty) in order to meet accounting standards and avoid a *qualified* audit report for inadequate disclosure. The draft guidance contains no equivalent provision.

58. In terms of what the draft guidance does have to say, we note that there is a lack of clarity as to the difference between sensitivities and stress tests. They both involve variations from the base case. A plain reading gives the impression that reverse stress testing is optional (appendix 1 paragraph 29). Is this intended?

Prudence – could be more simply, shortly addressed

59. We believe that the description of prudence, under the heading of stress testing (appendix 1 paragraphs 32-37), could be simpler. It does not seem necessary to say that prudence is about putting more emphasis on the downside than the upside. After all, stress testing isn't about the upside anyway. It has all of its emphasis on the downside already. The message of paragraphs 32-34 could be a much simpler, more direct one: the more risk a company has in its position or business model, the more stress the company has to be able to withstand.

60. Paragraphs 34-36 then seem to stray into commenting on accounting, suggesting that accounting measures do not "adequately" reflect risks – ie, implying some failing. Yet it's hardly fair, for example, to imply criticism of provisions accounting principles (for legal or regulatory issues) when the balance sheet must report a discrete figure and no such single figure could ever capture the risk, since risk is the possibility that it might turn out to be a different figure. Nor do we understand the remarks about "exuberant" and "unrealistic" fair values; fair value is a globally recognised model and nationally implemented in the UK; of course any apparent shortcomings in application would merit the FRC's attention, but that hardly seems a matter for the draft guidance.

Directors – responsibilities, assurance, non-listed companies

61. In relation to assurance (section 3), we believe that the wording needs to be carefully considered. The Board (as a whole, not any one committee of it) has inalienable responsibility for the conduct of the affairs of the company. Of course, it delegates matters to management under its control, and it instructs external parties to review matters and report; but it does not rely on assurance from others in the sense of laying off responsibility. The drafting needs to be clear about this.

62. Whilst we agree that material uncertainty reporting should be the same for all companies, albeit not on the model proposed by the draft guidance, we are concerned that the costs of imposing the process on unlisted or unquoted companies have not been assessed.

63. At several points the draft guidance refers to a "robust" assessment by the directors (eg, section 4 paragraphs 1 and 8, ISA (UK & Ir) 260 paragraphs 16-1 and A20-7). We are left

unclear whether this is in fact asking for the assessment to be done to a higher standard of care, skill and diligence than is required of directors by the law (see s174 Companies Act 2006), and if so why and what standard.

64. We note that a wider governance responsibility is identified as "determining the reserves from which any distributions will be made" (section 1 paragraph 16, section 3 paragraph 2). However, the reserves available under the Companies Act are a matter of preparing accounts in compliance with Act and thus with accounting standards, and then applying largely deterministic realisation rules to those figures. Instead the real issue is whether it would be wise to go ahead and make a distribution from statutorily available reserves in view of the company's expected future liquidity and solvency positions. It is quite clear at law that directors are neither compelled to distribute statutorily available reserves nor free to do so without further thought for the consequences.

Reporting – comprehensive findings or process?

65. Section 4 paragraphs 1 and 8 require that the board's confirmation of a robust process be "illustrated" with reference to specific issues. It appears, therefore, that if there were several issues, then the reporting need not cover them all but instead cover only some or one of them as an illustration. Is this intended?

66. Paragraph 8 also implies a preference for specifics rather than process description. We agree. However, we note that it also asks for information about how the board obtained assurance, whereas "how" is about process, and we expect that shareholders want to know about findings not processes.

Appendix C – Answers to the particular consultation questions

Set out below are brief answers to the consultation questions. The background to our answers is dealt with at more length in Appendices A and B.

Question 1: 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? If not, why not, and what changes should be made to the Guidance?

No. The proposed guidance would make material uncertainty disclosure into a version of narrative reporting, rather than a disclosure for the purposes of the accounts giving a true and fair view. The lack of a clear distinction between the two has serious adverse consequences for both Listing Rules and financial reporting purposes

Question 2: Do you agree with the description in the Guidance of when a Company should be judged to be a going concern? 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? Is the term 'a high level of confidence' sufficiently understandable? If not, why not, and how should the description or term be modified?

No. The test sets too high a hurdle. "High level of confidence", the meaning of which is not clear, is only one factor contributing to that too high hurdle.

Question 3: 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?

Yes, we agree that, under the current basis of disclosure of material uncertainties, the need to take actions outside the normal course of business ought to be an indicator of possible material uncertainty; but we do not think that the draft has developed this sufficiently yet for practical guidance.

Question 4: 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?

We neither agree nor find it sufficiently clear.

Question 5: 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'? 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. However much the going concern basis of accounting is explained in the guidance as being different from the definition of a going concern for narrative reporting purposes, we do not believe that the distinction will take root in "hearts and minds". So there will be more not fewer expectation gaps.

In our response to the Preliminary Report we suggested that in fact the Code/ Listing Rules would need to be changed to effect the necessary improvements in narrative reporting, rather than, as here, leaving them unchanged. We also noted in that earlier response that the Panel seemed to be minded that material uncertainty disclosure was a convenient vehicle, or "makeshift" arrangement, dating back to 1992, for introducing some forward-looking financial viability reporting. Whilst we don't agree that that was its purpose, we are concerned that the present proposals would certainly make material uncertainty disclosure into a *de facto* vehicle for business model narrative reporting; and, further, we are concerned that the proposals would also convert the Listing Rules going concern statement into a "makeshift" lever to force business model narrative reporting. Instead what is needed is a direct requirement for such narrative reporting, not a re-purposing of other, different requirements.

Question 6: 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? 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 do not agree with this interpretation of accounting standards nor with the threshold (factors) proposed.

Question 7: 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. The draft guidance is not consistent with accounting standards.

Question 8: Do you 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? 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?

No. We do not believe that the draft guidance is sufficient. Please see our comments in Appendix B.

Question 9: Do you agree that the approach taken in Section 4 of the Guidance in implementing the disclosures in Recommendation 4 is appropriate? Is the term 'robustness of the going concern assessment process and its outcome' sufficiently clear? 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? 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?

Please see our comments in Appendices A and B.

Question 10: 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? If not, why not and what changes should be made to the auditing standards?

Please see our comments in Appendix A as to how, within a reframed narrative reporting requirement for companies, the audit reporting proposals would need to be recast.

Question 11: 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? 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? 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?

We agree that, within the current basis of material uncertainty, reliance on central bank liquidity facilities may be within the normal course of business of a bank and not indicate a material uncertainty. However, we do not believe that that would be consistent with the general approach proposed in the guidance (or that the tests set out in the supplement are achievable).

Question 12: Do you consider the proposed implementation date to be appropriate? If not, why not and what date should the application date be?

No. Please see our earlier comments.

Question 13: Do you believe that 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?

We believe that there will be a very significant increase in the number of companies reporting that they are not unqualified going concerns and disclosing material uncertainties. As we explain earlier, based on our reading of the proposals we believe that, necessarily, virtually no company will be able to make an unqualified going concern statement and nearly all companies will disclose material uncertainties. Before considering the cost of implementing the proposals, we do not believe that the proposals are, on the whole, beneficial.

Question 14: 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. Please see our comments in Appendix B.

Question 15: 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?

Please refer to the rest of this response.