THE
INSTITUTE OF
CHARTERED
ACCOUNTANTS
OF SCOTLAND

Response from
The Institute of Chartered Accountants of Scotland to
The Sharman Inquiry

# Call for Evidence
# Going Concern and Liquidity Risks: Lessons for Companies and Auditors

**8 July 2011**

## INTRODUCTION

The Institute of Chartered Accountants of Scotland welcomes the opportunity to participate in the call for evidence on going concern and liquidity risks: lessons for companies and auditors. The call for evidence was discussed by the Institute's Audit and Assurance Committee and Business Policy Committee and this response is a summary of their combined views.

The Institute is the first incorporated professional accountancy body in the world. The Institute's Charter requires its Committees to act primarily in the public interest, and our responses to consultations are therefore intended to place the general public interest first. Our Charter also requires us to represent our members' views and protect their interests, but in the rare cases where these are at odds with the public interest, it is the public interest which must be paramount.

## RESPONSE

We believe that the focus of the Inquiry should be on improving the reporting framework. Going concern is a particularly narrow concept which needs to be put into context through a company's narrative reporting. We therefore believe that, rather than focusing on processes, the Inquiry should concentrate on improving transparency through disclosure. Going concern and liquidity risks should not be considered in isolation – rather they fundamentally underlie a company's activities day to day. We do not believe there are material weaknesses in companies' processes for reviewing going concern and liquidity risks.

***The focus of our response to the Inquiry is on the practical changes we believe should be made surrounding the reporting framework and does not seek to reply to the individual questions raised by the call for evidence.***

The overwhelming views we received from our Committees centred on what has driven the need for the call for evidence. In the wake of the financial crisis, the Financial Reporting Council (FRC) produced guidance for the directors of UK companies in October 2009 on going concern and liquidity risk. This was welcomed by both corporates and auditors at the time and we believe that companies and their boards have been actively looking at and following this guidance in preparing their annual reports and financial statements. We believe it is becoming more evident that directors are now assessing the viability of their companies on a more continuous basis leading to real-time revisions and updates to their forecasts and forward plans.

The result has been an improvement in companies' processes and a better quality of reporting of going concern and liquidity risks. However, we believe the reporting must continue to improve. Auditors are well aware of the part they have to play in this process and again we believe there has been progress here, where the new International Standard on Auditing (UK and Ireland) 570 on going concern (applicable for accounting periods ending on or after 15 December 2010) will play its part going forward.

We would agree there is no room for complacency but would ask for the Inquiry to be clear on what specific problems has led it to conclude that such a call for evidence is necessary. We do not believe there should be a desire to ensure that no corporate, large or small, ever fails again. Our market-based economy is built on competition that does not guarantee winners every time and nor should it. What we should have is a system that is robust enough to withstand any "curve balls" thrown at it and have corporates that are strong enough to survive through tough years.

The core principle that "share ownership carries risk" is one that we believe should not be artificially doctored or manipulated and we would caution the Inquiry not to create any false hope for shareholders and the market that financial reporting surrounding going concern and liquidity risks will act as a panacea to companies that may be in difficulty.

We also believe that there are dangers in focussing too much energy and effort on the narrow concept of going concern, which in itself can be difficult to effectively portray to the reader of a set of financial statements. The main issue should be with the information in general that is contained in the annual report and its overall usefulness.

From an investor's perspective, we suspect that the ordinary black or white information, while still very interesting and relevant, is not at the heart of the investor's needs. We would suggest that the grey areas at the margins are what the investment community is striving to understand and we believe this is only possible through clearer and more descriptive financial reporting, for example the sensitivity analysis surrounding working capital forecasts.

**Corporate Reporting**

There are already many rules and regulations corporates have to adhere to when looking at their disclosures. UK company law stipulates that the company's management must describe the principal risks they face in the business review which forms part of the directors' report. The Financial Reporting Review Panel (FRRP) has concentrated particularly on the area of risk reporting and noted that companies are not always disclosing the key risks to their business. Understanding the risks to a company's business model is crucial to understanding the rationale underlying its status as a going concern. We believe that the FRRP should continue to focus on this area.

International Accounting Standard (IAS) 1: Presentation of Financial Statements highlights that when preparing financial statements, management shall make an assessment of an entity's ability to continue as a going concern and that financial statements shall be prepared on a going concern basis unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so.

When management is aware, in making its assessment, of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, those uncertainties shall be disclosed. They should also disclose, in the notes, information about the key assumptions concerning the future, and other key sources of estimation uncertainty at the balance sheet date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year. Finally, an entity shall disclose information that enables users of its financial statements to evaluate the entity's objectives, policies and processes for managing capital.

We would accept that some corporates may be poorer than others in eloquently explaining their judgments and risks; and that disclosures which could be termed as "boiler-plate" or bland are not helpful to the user. This needs to be addressed in order to provide shareholders and other stakeholders with the right information and not information simply for the sake of it.

ICAS firmly believes that the value in disclosure comes from it being made specific to the situation of the company and not from a standardised text.

The recent ICAS Future of Assurance project delivered a number of recommendations that would result in better information for shareholders and in particular cited the disclosure of key business and management assumptions as being a significant step forward.

ICAS believes the following recommendations are relevant to the work of the Inquiry:

- ***The narrative corporate report should tell a clear, logical and understandable "story" of the company which is then signed off by the Board as being "balanced and reasonable".***
- ***The narrative should detail the rationale for concluding that the business is a going concern, with potential for the period of going concern to be longer for certain companies where this is considered appropriate. The rationale should include:***
    - ***Disclosure of the key assumptions on which the Board has based its assessment;***
    - ***A clear exposition of the business model and the strategy;***
    - ***An articulation of the key risks facing the business (these should be limited in number and should reflect the risk discussions of the Board);***
- ***The narrative should also include the significant judgements of the Board in producing the annual report and financial statements.***

It is also worth noting in this context that ICAS is currently working with the New Zealand Institute of Chartered Accountants on an IASB sponsored project to look at reducing financial statement disclosures. The project will review the levels of disclosure requirements in existing International Financial Reporting Standards (IFRS) and recommend deletions and changes to disclosure requirements – for annual financial statements of publicly accountable entities.

We will ensure the final report from the project is shared with you in due course.

**Auditors**

We believe that auditors are performing more work on going concern and there is a noticeable increase in the level and detail of documentation that is held on an audit file. For some companies, though this can be disproportionate as going concern may not be a significant issue (e.g. a family run cash rich company with few external creditors and no external shareholders).

Auditors are guided in this area by International Standard on Auditing (UK and Ireland) 570 on going concern (applicable for accounting periods ending on or after 15 December 2010) and we believe that going concern is one of the key items discussed in any correspondence between the company and their auditors.

The auditor will work to obtain evidence to support the continuing availability of funding facilities for companies and will test the key sensitivities as well as the underlying assumptions from management for reasonableness. The degree of work undertaken by the auditor and the judgement of risk will, as it should do, vary from company to company and also by sector.

We note that in certain sectors the work undertaken on going concern has increased exponentially – for example construction and retail. We would also comment that property companies would appear to be more and more subject to an emphasis of matter paragraph in the audit report – a result of the current economic conditions.

This brings with it certain reservations about the emphasis of matter paragraph, which is generally viewed as a qualification even though technically it is not. We are concerned about the apparent lack of understanding of this paragraph by some stakeholders and the consequences as a result of this. We believe there should be no material effect on a company of including such a paragraph and that perhaps some further work and education on explaining in simple terms the reasoning behind and effect of such a paragraph may be helpful.

**The Audit Committee**
Following from our Future of Assurance project, ICAS recommended that the auditor should give an explicit opinion in the audit report that they have reviewed the Board's assessment of going concern and are satisfied that it is reasonable. This is simply making explicit in the audit report the current requirement under ISA 570.

We also recommended that the auditors should give an opinion that the narrative report (other than the financial statements) is "balanced and reasonable". This would cover the new narrative we referred to earlier and therefore the board's rationale underlying the going concern opinion would be covered by the "balanced and reasonable" opinion.

Finally we recommended greater transparency from the audit committee in an expanded audit committee report. This would include:

- ***A matrix style report which maps the key risks disclosed by the board in its report to the assurance processes used to gain comfort over those risks;***
- ***How the audit committee satisfied itself of the appropriateness of management's significant judgements – including a substantive discussion of those judgements; and***
- ***Details of the key areas discussed between the audit committee and the external auditor during the audit process, including the main areas of audit challenge.***

**Regulated Entities**
With regard to regulated entities, the reporting that is required by a regulator is often very relevant to going concern and the work of the auditor: an example of this being the banks requirement to report on capital and liquidity. We believe that the regulator needs to share this information with the auditor where there is a significant issue identified, in the same way as the auditor should share relevant information with the regulator.