Response to FRC consultation
January 2014

Local Authority Pension Fund Forum

LAPFF response to FRC consultation on Risk Management, Internal Control and the Going Concern Basis of Accounting

The Local Authority Pension Fund Forum (LAPFF) was set up in 1991 and is a voluntary association of 59 local authority pension funds based in the UK with combined assets of approximately £120 billion. It exists to promote the investment interests of local authority pension funds, and to maximise their influence as shareholders to promote high standards of corporate governance and corporate responsibility amongst the companies in which they invest.

LAPFF was very positive on the outcome of the FRC Sharman Review in 2011[1], which in a very comprehensive manner dealt with:-

- the going concern basis of accounting, as an accounting policy
- the "commonsense" position regarding what is necessary to be a going concern, including the economic drivers of being a going concern, which include capital, profitability, and the interaction with limited liability. We also believe to be a going concern it is necessary to have proper financial control.

The Sharman Review also covered the problems with International Financial Reporting Standards (IFRS) of balance sheets and profit and loss accounts not giving a suitably prudent basis on which to conclude on whether a company's financial position supports being a going concern or not. The ultimate results of this have since been borne out at a number of banks including the Co-op.[2]

However matters seem to have been confused by lobbying from the accounting profession and this FRC proposal links going concern with the approach of the FRC's existing Internal Control and Risk Management Guidance ("Turnbull approach"). In LAPFF's view this is particularly unwise in principle and law for the reasons we set out below.

[1] See also http://www.lapfforum.org/TTx2/Publications/consultations

[2] Basically IFRS does not show whether a company has capital or whether it is generating cash based profits, both being prerequisites to being a going concern without calling on shareholders for additional funding, or requiring creditors to convert their interest into equity.

1 The "Turnbull approach" did not identify problems in banks

The Sharman Review came about due to criticism of the auditors of banks by the House of Lords Economic Affairs Committee. The existing Turnbull approach was clearly ineffective in relation to banks and non-regulated near-bank financial services companies such as Cattles plc.

LAPFF notes that the FRC has not undertaken a review of the ineffectiveness of the Turnbull approach in relation to those financial services companies that failed. It is therefore odd in principle to attach the subject matter of the Sharman Review to an approach which has a less than exemplary track record.

LAPFF also notes that a recent decision of the Prudential Regulation Authority (PRA) in respect of Standard Chartered Bank plc has led to risk management being taken away from finance directors[3]. This has broader implications for the existing approach of the FRC to risk management in general.

2 Going concern is an essential element of the true and fair view

LAPFF fully agrees with the FRC that that going concern is an accounting policy. However the implication of that - which the FRC has not addressed in this proposed approach - is that the accounting going concern is then a subset of the true and fair view requirement.

If a company is not a going concern the profits, losses, assets, liabilities, reserves and net assets as stated in the accounts may need to be materially different. The accounts either give a true and fair view as a going concern, or they give a true and fair view on a break-up basis.

As a point of law, true and fair view is a matter for an independent auditor opinion. If an auditor is not forming a proper opinion on whether a company is a going concern or not, they are not actually providing an opinion on whether the accounts give a true and fair view on the going concern basis.

3 The "Turnbull approach" of the proposed guidance is a limitation of scope

LAPFF notes that the Turnbull approach is based on similar principles to the 'COSO Framework' which is originally a product of PwC USA[4]. LAPFF also notes that both IFRS and Basle II are based on the constructs of the COSO Framework. Problems that arose from those cases are covered in an appendix to this submission.

COSO is concerned with giving assurance on the processes dealing with the risk perceptions of management given their chosen strategy. This approach is flawed if, for

[3] http://uk.reuters.com/article/2013/12/16/us-stanchart-uk-risk-idUSBRE9BF0JC20131216
[4] The Committee of Sponsoring Organisations of the Treadway Committee (Coopers & Lybrand and the American Institute of Certified Public Accountants (AICPA) sponsored)

example, the strategy chosen is in fact destroying value and hence capital, and the accounting is not showing it.

Therefore a major problem with the Turnbull approach is that it is inconsistent with the primary concept of an independent auditor having independent eyes and voice for the benefit of the providers of capital as well as for the broader public interest. The Turnbull approach amounts to a limitation of scope, as the auditor is merely shadowing enquiries and assertions already made by directors. Whatever Turnbull was covering in banks which failed, it was not covering the commonsense position of things relevant to being a going concern.

The Turnbull approach therefore should not form part of an independent statutory audit in respect of going concern. It places the auditor in a subordinate position with respect to enquires made by directors and their opinions.

Furthermore, in terms of basic business economics and law, whether the going concern basis is appropriate depends on collective shareholder and creditor opinion, not merely the hopes and assertions of directors. Shareholders and creditors may or may not support the continued funding of the company and shareholders also have the prerogative to wind up a company at any time. This is partly the reason why independent auditors communicate formally to the shareholders, not the directors, at the AGM.

Conclusion

In conclusion, LAPFF supports the original Sharman proposals, not the FRC proposed amendments. Recent FRC statements on the quality of audits at UK banks would suggest that auditors should be undertaking their basic task properly as opposed to providing assurance against financial reporting standards and the Turnbull approach that exist in their current form largely due to the profession’s influence.

Given the centrality of risk management and financial control to a company being considered a going concern, there seems to be little in the Turnbull/COSO approach that is not already incumbent for the auditor to provide an opinion on the true and fair view. It is also the legal requirement for the auditors to state whether proper accounting records (and thus proper records of financial control) have been kept or not.

APPENDIX A

1. Regarding the Basle II use of the COSO Framework.

   Basle risk weightings were based on company management's perception of risk and their perception of their risk management systems. That approach has been discredited by the Prudential Regulation Authority, which is now doing these calculations independent from company management.

   LAPFF also notes that the proposed Solvency II directive was also based on the COSO model, but has now been abandoned.

2. Regarding the COSO Framework and defects in IFRS.

   The way in which IFRS deals with capital maintenance (i.e. whether shareholders' funds actually exist or not) is not an integral part of the standards framework. Such matters are therefore not public and hence not audited. Instead, such information is internalised and private, which leads to the clear risk that capital maintenance is not properly addressed at all.