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Dear Marek

## **Implementing the Recommendations of the Sharman Panel - Revised Guidance on Going Concern and revised International Standards on Auditing (UK & Ireland) ("the Consultation Paper")**

Ernst & Young is pleased to have the opportunity to respond to the Consultation Paper. We are also grateful to the FRC for organising the public meeting on 25 April 2013 which provided a number of very useful insights on the key issues arising.

High quality disclosure and reporting of matters relating to an entity's ability to continue as a going concern are critical to all stakeholders, which is why we were supportive of the Panel's final recommendations.

That said, for the reasons set out in this letter, we believe that the FRC's implementation proposals require significant amendments if they are to achieve the objective of higher quality reporting in this area.

We set out in this covering letter our principle areas of concern. Our response to questions in the Consultation Paper can be found in the attached appendix.

### **Two definitions: a risk of being misunderstood**

We understand the fundamental distinction drawn between preparing the accounts on a going concern basis and an entity being a "going concern" as now defined by the FRC. Indeed, we believe that it is clearly articulated in the Consultation Paper. However, there may not be a clear understanding of the distinction and of its implications amongst all stakeholders. It might also give rise to a lack of comparability in the disclosures of UK listed companies with their international peers. In view of this, the FRC should reconsider whether this distinction should be formalised in the form of a new reporting model before efforts to engage with the IASB and IAASB on a common international approach to these issues has been completed.

### **Complex to implement**

Our own consideration of the proposals and our discussions with many other stakeholders has highlighted concerns that preparers and users might struggle to understand and implement the proposals effectively. This risk could be mitigated by the inclusion in the guidance of a "decision tree" or illustrative guidance to make clear the FRC's intentions. We understand the

FRC's concern that illustrative examples could give rise to "boiler plate" disclosure which would counter the FRC's objective to encourage entity specific disclosure. We believe this risk may be overstated. The 2009 Guidance for Directors on going concern provided clear guidance and examples, which has not led to boiler plate disclosures. One way in which the FRC could address this concern would be to build more explicitly on the 2009 guidance, and in particular expand on the examples used in that guidance by setting out likely considerations for directors.

### **Inconsistencies**

The area we have found the most challenging (as have stakeholders with whom we have discussed the subject) is the basic definition of going concern in paragraph 12 and apparent inconsistencies in the guidance. The degree of confidence directors can have about the ability of their company to continue as a going concern is inversely related to the length of the future period they are considering. Thus, assuming that "high level of confidence" is not intended to mean "virtually certain" (confirmed at the FRC's public meeting on 25 April 2013), we anticipate that directors may well, in appropriate circumstances, be able to conclude that they have a high level of confidence looking forward for at least 12 months (the apparent test in paragraph 20 of section 2). However, if the "foreseeable future" is extended to cover the business or economic cycle, we doubt that many directors will be able to make a conclusion with a high degree of confidence; assuming the directors are able to determine the relevant economic cycle given current economic circumstances. If that happened the number of "material uncertainties" reported would rise considerably, potentially giving rise to confusion and concern in the minds of users and other stakeholders.

It is critical that the FRC should provide clearer guidance in this area. We believe that the focus of the "high level of confidence" test should be a period of at least 12 months from the date of signing the accounts. A clear articulation of this test would assist all stakeholders. We recognise that this puts the focus of the going concern assessment back onto shorter term considerations, but we believe that concerns about the longer term viability of a company's business model can be addressed by ensuring appropriate disclosure of longer term issues facing the company, as part of the discussion of business model and strategy in the new Strategic Report.

### **Effect on Small and Medium-sized Enterprises**

With the exception of Code provision C1.2, which clearly does not apply to SMEs, the guidance needs to be much clearer in how it applies to SMEs. The FRC should be explicit in the guidance that the more extensive disclosures required would be disproportionate for SMEs. Our preference would be for the FRC to develop a separate section or appendix as stand alone guidance for SMEs.

### **Timetable for implementation**

We are concerned that the timetable for implementation may be unachievable for some companies. Even if the FRC issues its guidance in line with its original timetable, companies with 30 September year ends will have limited time to implement the new guidance, and similar issues would arise for companies with 31 December year ends in addressing their 30 June interim reporting obligations.

We encourage the FRC to re-consider its timetable, given the significance of going concern disclosures and the critical importance of "getting it right"; particularly in light of other changes in reporting requirements which take place at the same time e.g., the new Strategic report, revised remuneration reporting, the requirements under the Code to report on "fair, balance and understandable", etc.

In practice we do not believe it will be possible for the FRC to adhere to its original timetable given the number of areas arising from the Consultation Paper which will need to be reconsidered and possibly consulted upon. We therefore recommend that the application of the guidance be deferred - possibly such that initial application is in respect of December 2014 year ends.

We hope that our comments are helpful. If you have any questions please do not hesitate to contact me. We would be very happy to participate in any further consideration of these issues the FRC decides to undertake.

Yours sincerely

A handwritten signature in blue ink, appearing to read 'Robert Overend', with a horizontal line underneath.

Robert Overend  
Ernst & Young LLP

## Appendix - Detailed Responses

1. *Do you agree that the Guidance appropriately provides the clarification recommended by the Panel as to the purpose of the going concern assessment and reporting and is appropriate? If not why not and what changes should be made to the Guidance?*

The distinction between being a going concern and preparing accounts on a going concern basis, although clearly articulated, may not be fully understood by all stakeholders. It could introduce a lack of comparability with wider international practice and disclosures, unhelpful for UK corporates and their shareholders and potential investors.

We also believe that parts of the Guidance are unclear and may be difficult for preparers and users to understand and implement effectively. For example, the importance and relevance of the distinction between actions “inside or outside” the company’s normal activities as discussed further below. We recommend that the Guidance be redrafted to build more explicitly on the 2009 Guidance, further developing the examples therein and including a clear “decision tree” which would assist directors in reaching their conclusions and users in interpreting the resultant disclosures.

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?*

We do not believe that preparers will find it easy to apply the guidance without further clarification. As we note in the covering letter, we believe the guidance could be clearer as to whether directors need to have a high level confidence over the business/economic cycle, or merely over a period of at least twelve months from approving the accounts. We believe that the FRC should clarify that it is the latter which directors should consider. This should be supplemented by a requirement that longer term threats to the entity’s commercial viability are discussed in conjunction with the business model in the Strategic Report.

Our discussions with stakeholders indicate considerable uncertainty as to level of the hurdle set by “a high level of confidence”. We recognise that the FRC will find it hard to define the term more precisely and ultimately it must be a matter for directors’ judgement. However, it would be helpful if the guidance was clear as to whether this is a “virtually certain” test. Beyond that we think this is an area where providing examples to illustrate the underlying thinking would be of value. For example, we think that preparers (and other stakeholders) would find it very helpful if the FRC were to set out a consideration of what might cause the directors of the company in example 2 of Appendix II of the 2009 Guidance, to conclude that they had a high level of confidence (or not).

We agree that the directors’ consideration should include all actions they would consider

taking. However in that context we do not find that the distinction of “inside or outside the entity’s normal course of business” is very useful. If the test is the degree of confidence that the directors have that actions can be successfully implemented (and there is appropriate disclosure), it is not clear to us why it is relevant whether such actions are within or outside “normal activity”. Clearly it is less likely that directors will have a high degree of confidence about activities outside the normal course of an entity’s activities, but that could be made clear in the guidance.

Finally, we are concerned by the suggestion in the guidance that even if the directors have a high level of confidence there might still be “material uncertainties” to disclose. This would add unnecessarily to the complexity of the reporting model. As discussed above, we think that concerns about longer term viability can be appropriately addressed in the Strategic Report.

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 the Guidance explains their nature sufficiently clearly? If not why and what changes should be made to the Guidance?*

As set out in our response to Question 2, we do not find the distinction between actions within and outside the normal course of business very helpful. We suggest limiting the discussion to make it clear that directors are, in most cases, likely to find it harder to have a high level of confidence about actions outside the normal course of business than those within the normal course of business.

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

Please see our response to Question 2 above. The current economic environment in the UK has caused many to challenge whether it is possible to discern clearly what the “economic and business cycles” might be. These concepts therefore have to be used with caution.

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 judgment and is not absolute? If not why not and what changes should be made to the Guidance or the Code requirement.*

As set out in our covering letter and our response to Question 1 above, we believe that the distinction the FRC is seeking to draw is clearly explained in the Guidance. However, we are concerned that in practice the distinction may not be properly understood by all stakeholders and will introduce inconsistencies in reporting between UK companies and their international peers.

We believe that the Guidance makes clear that all decisions on going concern are judgements rather than absolute statements.

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?*

The determination of whether there are material uncertainties must ultimately be a matter for the judgement of the directors and auditors of the company. To that extent we agree with the FRC. However, we are concerned that the draft guidance on this point is not always clear. The problem in large part arises from the “two stage” consideration of “going concern” and “the going concern basis of preparation” (the latter being the relevant context for material uncertainty disclosures under the standards) proposed by the Guidance. This is one of the areas where we believe significant clarification is required.

Our analysis would be as follows:

If the directors have a “high level of confidence” then preparation of the accounts under the going concern basis would be appropriate. We would not expect “material uncertainty disclosures” under FRS 18 or IAS1.

If the directors do not have a high level of confidence, but nevertheless consider that the going concern basis of preparation is appropriate, it is highly likely that material uncertainty disclosures will be required. Put another way, the directors would need to consider very carefully why such disclosures are not required if they do not have a high level of confidence.

This analysis is predicated on our view that: a) high level of confidence is not a “virtually certain test” because the possibility that there might not be “material uncertainties” notwithstanding failing the “high level of confidence test” becomes greater the higher one sets that test; and b) that the foreseeable future is the “at least 12 month period” we discuss above.

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

We have not identified anything that is clearly inconsistent with current standards. However, it is not clear whether the proposals have developed in line with international consensus. We believe it is important that the final guidance is set within the context of the FRC’s discussions with the IASB and IAASB.

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 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?*

The ultimate responsibility for making the going concern assessment and being satisfied that their supporting process is appropriate to the circumstances of the entity rests with the directors. The guidance is likely to be helpful for directors in this regard but we think the provision of more specific examples would assist directors further in evaluating whether their approach is appropriate.

In certain circumstances it may not be necessary for the directors to undertake all the various procedures discussed in Section 3 in order to have undertaken "a sufficiently robust process". In our view, it is important that the guidance and any examples the FRC develops to assist directors makes that clear. It might also be helpful to provide examples of stress tests and reverse stress tests outside the financial services sector, as we are not sure that these concepts are always fully understood.

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?*

As we note in our response to Question 8 responsibility for consideration of going concern rests with the directors and it is for them to determine what constitutes a sufficiently robust process. With the addition of the word "sufficiently" to the requirement we think the FRC's intention will be clear. We agree that directors should be explicit as to what period they have considered in making their going concern assessment.

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?*

The requirements proposed in the revised ISAs are consistent with the FRC's wider approach to enhancing auditor reporting and in principle we believe that it is an appropriate approach. That said, the requirements of ISA 260 and ISA 700 have become increasingly complex for auditors to understand and apply. As we have said before, we believe that the FRC should develop further supporting practical guidance for auditors.

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 with position articulated in the Supplement, but it seems to us that this conclusion reflects an implicit judgement on the degree of confidence that the bank (and others) will have central bank support. In practice the degree of confidence might change over time. The FRC may wish to consider this in finalising the Guidance.

12. *Do you consider the proposed implementation date to be appropriate? If not why not and what date should the application date be?*

As set out in our covering letter, we do not believe that the current proposed application date is appropriate. Even if the FRC were to finalise the guidance in accordance with its current timetable, we do not believe that companies with a September 30 year end will have the time to apply the guidance properly. In practice we anticipate that the FRC will need to undertake a thorough review of the Guidance in the light of feedback arising from the current consultation process, which suggests that the current timetable will not be achievable. We therefore think that the application date should be deferred until 31 December 2014 year ends, which will permit sufficient time for a thorough reconsideration by the FRC and for companies to consider the implications of the new requirements.

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*

As we have noted in our covering letter and responses above we believe that the guidance needs further development to make it much clearer if it is to provide the desired benefits.

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?*

We believe the FRC should develop a separate section or appendix dealing explicitly with SMEs. This would make the question of how the Guidance applies to SMEs much clearer.

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?*

We have nothing further to add.