Investment Management Association

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Dear Catherine

Risk Management, Internal Control and the Going Concern Basis of Accounting

IMA represents the asset management industry operating in the UK. Our members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. They are responsible for the management of approximately £4.4 trillion of assets, which are invested on behalf of clients globally. These include authorised investment funds, institutional funds (e.g. pensions and life funds), private client accounts and a wide range of pooled investment vehicles. In particular, IMA members manage holdings amounting to just over 30% of the domestic equity market.

In managing assets for both retail and institutional clients, IMA members are major investors in companies whose securities are traded on regulated markets. IMA welcomes the FRC integrating its guidance on going concern, risk management and internal control and embedding risk management into a company's governance processes.

In the current economic climate it is particularly important that investors, as the providers of risk capital, understand the risks to a company being able to continue as a viable business and meet its liabilities as they fall due. However, investors have been concerned about the lack of transparency as to the uncertainties that underlie a company's viability and have reservations about certain of the proposals in the consultation paper. We set these out below and in the attached Annex our comments on the specific questions raised.

- The guidance as drafted has a confusing structure, long sentences and introduces new terminology all of which could limit its use in practice. Moreover, it would be helpful if it explained how it fits in with other of the FRC's initiatives such as the guidance that has recently been subject to consultation on the strategic report.

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- The guidance focusses on solvency and liquidity risks but the former, i.e. solvency risk, may not be relevant for non-financial services companies and there are other risks that could impact a company's ability to continue as a going concern such as reputational risk, operational risk, breach of licences etc. The focus on solvency and liquidity risk is too narrow and should be extended.

- The current drafting of C.2.1 in the Corporate Governance Code conflates the issue of the going concern basis of accounting and a company continuing in operation and its future viability. It also means that material uncertainties which threaten a company's ability to meet its liabilities and continue in operation would not be disclosed. Investors value this information in that it helps ensure companies do not abuse their limited liability protection. In conclusion, we would suggest the following to replace the proposed C.2.1:

  "*The Board should confirm in the annual report that it has carried out a robust assessment of the company's condition, including its solvency and liquidity, based on current circumstances and any related contingencies and risks. It should also confirm that based on that assessment, it considers that the company will be able to meet its liabilities as they fall due, continue in operation for the foreseeable future and that, by reference to the audited accounts and financial controls, the company is a going concern. The Board should report any supporting assumptions and material uncertainties to these confirmations, and how they are being managed"*

  We would welcome the opportunity of discussing this with you as the FRC develops its thinking on changes to this section.

- The UK asset management industry invests internationally – around 67% of all equities managed are listed overseas – in other EU counties or outside the EU. In places the proposed guidance introduces new terminology and seeks to redefine certain concepts that are in IFRS. For example, we understand that the IASB is considering what should be disclosed in relation to going concern under IAS 1.

  Ideally concepts and terminology should be standardised in corporate reporting and auditing standards internationally to avoid unnecessary confusion and complexity. Moreover, in developing policy on corporate reporting and auditing, it would be helpful if the FRC sought to influence the international agenda and ensure there is comparability globally as opposed to developing a separate regime for UK companies.

We trust the above is self-explanatory. However, please do contact me if you require any clarification of the points in this letter or if you would like to discuss any issues further.

Yours sincerely

Liz Murrall
Director, Corporate Governance and Reporting

ANNEX

IMA's ANSWERS TO THE SPECIFIC QUESTIONS RAISED

IMA's answers to the specific questions raised are set out below.

Section 2: Guidance on risk management and internal control

1. The draft revised guidance seeks to address aspects of the board's responsibilities in more depth. The FRC would welcome views on whether the draft revised guidance achieves these objectives, and on the structure of, and level of detail in, the draft revised guidance.

IMA considers it sensible for the FRC to bring its guidance on going concern, risk management and internal control into one place. Providing a single source of reference for companies should make the guidance easier to follow. We also consider it important that companies incorporate their assessment into their on-going processes for setting strategy, risk management and business planning.

However, we consider the guidance as drafted is unwieldy and confusing. Thus whilst the page 3 of the consultation states that "the revised guidance seeks to address these [as set out above] aspects of the board's responsibilities in more depth", it is unclear how the points detailed are carried through to the guidance itself. The confusing structure, long sentences and introduction of new terminology make the guidance difficult to read and could limit its use in practice. Moreover, it would be helpful if the guidance explained how it fits with other of the FRC's initiatives such as the guidance that has recently been subject to consultation on the strategic report. Other points of detail are:

- the various references to existing guidance in the introduction to the new draft could be confusing to users in the future and should be removed; and
- the introduction also states that the FRC issues separate guidance on solvency and liquidity risk and the going concern basis of accounting for other companies but page 1 of the consultation states that the FRC will begin consultation on this in the near future. This position needs to be consistent.

Lastly, paragraph 5 of the new draft states "the Sharman Inquiry into going concern and liquidity risks concluded that the assessment of whether the company remained a going concern should be more broadly based than is required to determine the accounting approach to be taken". However, we do not consider that the arguments for and against the guidance now using the term "going concern" specifically to refer to the basis of preparation of the financial statements are fully articulated in the consultation paper and have concerns about this approach. We set out more detail on this point under question 9 below.

2. Sections 5 and 6 of the draft revised guidance address the design and process for reviewing the risk management and internal control system. They are largely unchanged from sections 2 and 3 of the current guidance ("Maintaining a sound system of internal control" and "Reviewing the effectiveness of internal control"), which the FRC considers remain fit for purpose. Do you agree or are more substantive changes to these sections required?

We comment above under question 1 on the structure of the proposed guidance. Sections 2 and 3 of the current guidance ("Maintaining a sound system of internal control" and "Reviewing the effectiveness of internal control") are well understood and whilst we agree that they do not need to be redrafted in Sections 5 and 6, we welcome the guidance now also referring to risk management systems and including more explanatory text. However, it would be helpful if Section 5 was clear that it is the responsibility of the board as a whole for the risk management and internal control system and that this extends beyond simply "establishing" to "maintaining" – both the references to the board and "maintaining" have been removed from/replaced in the existing guidance.

3. In 2005, a recommendation was added to the guidance that companies should "confirm that any necessary actions have been or are being taken to remedy any significant failings or weaknesses identified from [the] review". The intention behind this change was to encourage greater transparency about the outcomes of the review without placing companies in a position where they were asked to certify that the internal control system were effective. Many companies have simply cut and pasted the sentence from the guidance into their internal control statements. On its own, this does not indicate whether or not any significant failings or weaknesses have been identified. The FRC therefore proposes to amend the guidance to recommend more explicitly that the board should "explain what actions have been or are being taken to remedy any significant failings or weaknesses identified from that review". The FRC would welcome views on this proposed change to the guidance.

IMA welcomes this change in that many companies simply copied the sentence from the guidance into their internal control statements and gave no indication whether significant failings or weaknesses had been identified and what actions have been/are being taken to remedy them.

4. Appendices D and E contain questions which boards may wish to consider in applying the guidance, and indicators that may assist them in assessing how they are carrying out their responsibilities, the culture of the company, and the effectiveness of the risk management and internal control system. Appendix D is an updated version of the appendix to the existing guidance, while Appendix E is new. The FRC would welcome views on whether these appendices are of use to directors and, if so, how they might be improved.

Whilst this is mainly for directors to answer and subject to our comments elsewhere on the structure and format, we broadly support the aim of these Appendices in assisting directors.

Section 3: Implementation of the recommendations of the Sharman Panel

5. The 'high level of confidence' threshold and the 'foreseeable future' terms have not been taken forward in the Appendix B of the draft revised guidance. The high level of confidence concept has been retained only in the narrower and more appropriate context of the going concern basis of accounting (as discussed below). Do you believe that the approach taken in Appendix B of the draft revised guidance is appropriate? If not, how should it be amended and why?

Appendix B only refers to solvency and liquidity risks. We question the extent to which solvency would be relevant for non-financial services companies and would stress that there are other risks that could impact a company's ability to continue as a going concern such as reputational risk, operational risk, breach of licences etc. We consider the focus on solvency and liquidity risk may be too narrow and should be extended. In addition, the first paragraph refers to those risks that give rise to severe distress *if they* *materialise*. A company may be exposed to various risks many of which may have little or no likelihood of occurring or materialising but as drafted, they would still fall to be disclosed. We consider this needs to be addressed.

As regards the time period covered, Appendix B states that the board's evaluation "of the principal solvency and liquidity risks should consider what the board knows or should reasonably be expected to know about the future. The assessment does not have regard to a specific period". In the next paragraph it goes on to state that "given the accounting requirements (see Appendix C), the board needs to have a high level of confidence that solvency and liquidity risk can be managed effectively during at least 12 months from the date of approval of the financial statements, or else it is likely to have a going concern material uncertainty to disclose".

We consider these two paragraphs confusing. Moreover, whilst in making the going concern assessment, IFRS require management to take into account all available information about the future, this period need only be twelve months from the end of the reporting period whereas 12 months from the date of approval, as proposed, is consistent with International Standards on Auditing. We envisage tensions if auditors are expected to consider a longer timeframe than management. Moreover, we support a longer time frame in that it is more informative to shareholders and are concerned that uncertainties as to whether a company will continue in operation would not need to be disclosed under the proposals as set out in question 9 below.

Moreover, whist we have concerns about the drafting given the importance of this Appendix, once finalised we consider it should form part of the main guidance.

6. The term 'a high level of confidence' appears only in the statement that when severe distress has occurred or the directors judge that it will occur during the twelve months from approval of the financial statements "the board needs to have a high level of confidence that solvency and liquidity risk can be managed effectively" during that period. It is intended to indicate that there is likely to be a material uncertainty unless the directors are able to judge with a high level of confidence that they would have realistic options available to them for managing the identified risks in those circumstances. Do you agree with the guidance in Appendix C of the draft revised guidance? If not, how should it be amended and why?

We consider the issue of whether there are material uncertainties over the adoption of the going concern basis of accounting as set out in IAS 1 is something that the IASB should address. We understand that the IASB has been considering whether to provide more guidance on this and whilst the FRC may have an important role in the debate, we do not consider it should provide its own interpretation of IFRS. Moreover, the term "'normal course of business" is widely used and open to different interpretations as such we do not consider it suitable for use within Appendix C and for interpreting IFRS.

7. The FRC proposes to issue the 'Supplement for Banks' included in the January Consultation as a standalone document 'Guidance for the Directors of Banks: Solvency and Liquidity Risks and the Going Concern Basis of Accounting', making such changes as are necessary to keep it consistent with the final wording of the Code and the draft revised guidance. The resulting proposed amendments are shown in the draft now being published for comment concurrently with this consultation. Do you agree with the revised guidance? If not, what needs to be amended and why?

IMA's ANSWERS TO THE SPECIFIC QUESTIONS RAISED

We appreciate that the issue of going concern is complex for banks, but remain concerned that there is to be a specific supplement for them. Whilst, liquidly and solvency issues can escalate rapidly for the banking sector, there are other industries that have specific issues, for example, telecoms and extractive industries. Specific requirements for banks could open the possibility for a raft of industry specific standards that could compromise comparability.

Moreover, whilst we recognise that there may be tensions between corporate reporting and maintaining stability in the financial system, non-disclosure of significant support from the Bank of England needs to be considered in relation to other disclosures such as those required by IFRS 7 on liquidity.

8. The FRC proposes to implement the changes to the auditing standards proposed in the January Consultation, updated to reflect the other changes to the implementation approach. The requirement proposed in the January Consultation for the auditor to report if they have anything to add to what the directors' have included in the annual report and accounts in relation to solvency and liquidity risks and going concern, has been amended to require the auditor to report if they have anything material to add. Draft revised auditing standards are also being published concurrently with this consultation. Do you agree with the draft revised auditing standards? If not, what should be changed and why?

We agree that a company's auditor should consider the board's assessment and disclosures, and confirm whether it has anything to add or wants to draw attention to. In this regard, we have concerns about the board's proposed disclosures as set out in question 9 below.

9. The proposed revisions to Sections C.1 and C.2 of the Code are set out in full on the next page. The FRC would welcome views on whether the additions are required and, if so, on the detailed wording; and on whether the existing Provision C.1.3 (on the going concern statement) should be removed.

IMA considers the current express assurance in C1.3 that a company is a going concern is a vital protection for investors and creditors and we are concerned about its removal. As the Sharman Review Panel observed, there is confusion about what "going concern" means. First, there is the interpretation that the company can meet it liabilities as they fall due and secondly, whether it is appropriate to use the going concern basis of accounting. To address this, the FRC is proposing to apply going concern only to the technical issue of whether it is appropriate to use the "going concern basis of accounting".

However, we are concerned that the current drafting of C.2.1 conflates these two separate issues and would mean that material uncertainties which threaten a company continuing in operation (which as set out in question 5 may go beyond liquidity and solvency risks) would not be disclosed. As the Panel concluded the ability of a company to meet its liabilities as they fall due is, de facto, the higher hurdle, and an important one for investors in that it helps ensure that companies do not abuse their limited liability protection. The Panel suggested that that the board's assessment of the risks to the ability of the company to meet its liabilities should be done prudently, that it should be made for the foreseeable future, not just for one year. Any assumptions and qualifications to this should be clear and if viability is in doubt, it should be reported.

IMA's ANSWERS TO THE SPECIFIC QUESTIONS RAISED

We agree with this and suggest the following to replace the proposed C.2.1:

"*The Board should confirm in the annual report that it has carried out a robust assessment of the company's condition, including its solvency and liquidity, based on current circumstances and any related contingencies and risks. It should also confirm that based on that assessment, it considers that the company will be able to meet its liabilities as they fall due, continue in operation for the foreseeable future and that, by reference to the audited accounts and financial controls, the company is a going concern. The Board should report any supporting assumptions and material uncertainties to these confirmations, and how they are being managed".*

This should help address investors' concerns and improve the transparency of both companies and auditors on this issue. Whilst, initially there may be some apprehension about these disclosures, once they are better understood and become standard practice, investors will benefit from the greater honesty and clarity they will bring. We would welcome the opportunity of discussing this with you as the FRC develops its thinking on changes to this section.