TREASURY, RISK
AND FINANCE
PROFESSIONALS
ACT

The Association of Corporate Treasurers

Comments in response to
Call for Evidence by the Sharman Inquiry for the Financial Reporting Council: Going concern and liquidity risks: Lessons for companies and auditors

May 2011

July 2011

The Association of Corporate Treasurers (ACT)

The ACT is a professional body for those working in corporate treasury, risk and corporate finance. Further information is provided at the back of these comments and on our website www.treasurers.org.

Contact details are also at the back of these comments.

We canvas the opinion of our members through seminars and conferences, our monthly e-newsletter to members and others, *The Treasurer magazine*, topic-specific working groups and our Policy and Technical Committee.

We comment from the point of view of non-financial companies unless there is a public interest that would override that.

General

The ACT welcomes the opportunity to provide evidence.

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Please note that our comments relate to going concern issues for non-financial companies and may not be wolly applicable to other companies.

Existing guidance

The ACT was pleased to play a part in the development of the FRC's update for listed companies in November 2008 of its 2004 guidance as the effects of the crisis raised issues for many companies with a December year end. We also were involved in the revision of the guidance for companies generally that was dated October 2009.

We believe that the November 2009 document was well received by non-financial companies. Having drawn the attention of our members to the publication of the document, we received favourable comments about it both for its content and for the fact of its publication assisting in securing necessary attention to the issue within companies.

It is, of course, necessary to keep such documents under review and, accordingly, we welcome the current Inquiry.

However, we would like to make a number of observations.

Response to questions

Transparency of going concern and liquidity risk

Question 1

What combination of information about:

- *the robustness of the company's capital;*
- *the adequacy of that capital to withstand potential losses arising from future risks; and*
- *the company's ability to finance and develop its business model,*

would best enable investors and other stakeholders to evaluate the going concern and liquidity risks that a company is exposed to? How effectively do current disclosures provide this information?

It is important to distinguish between the long-term solvency of a company and its ability to survive in the relatively short-term. It is the latter which is normally the issue in the going concern question.

Long-term solvency can only be assessed with a full knowledge of three aspects of the company's strategy:

- what has it invested in and what will it invest in
- how is the investment financed/to be financed (equity *and* debt[1])
- how is risk managed/to be managed.

None of these questions can be answered without a knowledge of and taking into account the answers to the other two questions. There is never a "right answer" to these questions, but an un-ending series of judgements and compromises: a big test of management Information relative to this will appear in many places in the annual report. These provide background to the answer to the going concern question.

For companies with material intangible assets and significant real-options in the business the accounting balance sheet is often not that helpful in assessing long-term solvency. Balance sheets are not very forward looking[2].

[1] We note that some non-financial companies erroneously tend to regard capital as purely equity and preferred shares. In this context, debt is important. And debt is all debt including short-term debt: assumptions that working capital is self-financing/easily financed by short-term borrowing are unwarranted.

A non-financial company's failure is more normally associated with inability to pay creditors as they fall due and that is a liquidity – availability of cash – issue. The availability or expected availability of cash as it may be needed during the period after the approval of the accounts is crucial. A long-term inability to finance and develop its business model raises other questions but normally not the going concern question.

The long-term aspects touched upon variously in the annual report provide a necessary background to the answer to the going concern question.

We think that discussion of the long-term strategic questions in company reporting could be concerned and this is to some extent being addressed elsewhere. The larger problem is with un--listed companies, particularly small companies.

Question 2

What type of disclosures (if any) have been made into the marketplace outside annual an interim corporate reports about current stresses being expressed by the company and about the management of those stresses? How do these disclosures interact with the requirements to disclose principal risks and uncertainties in the Business Review and the required disclosure on going concern and liquidity risk in the annual and interim financial statements?

For listed companies, Listing Rules and Transparency obligations are important. Companies anticipating financial distress will sometimes hold analyst briefings to coincide with information to shareholders, the better to explain what they are doing. Private and small companies commonly suffer in silence until disaster looms.

Question 3

Are there any barriers within the current corporate reporting environment to companies providing full disclosure of the risks associated with concern and liquidity both within and outside the company's annual an interim reporting? Are there any changes that might be made to encourage companies to give fuller and more transparent disclosures in this respect?

The greatest barrier for companies providing full disclosure is the fear that making any disclosure about the possibility of financial distress may precipitate actions such as the loss of lines of credit, availability of trade-support services such as the issuing of letters of credit and provision of derivative risk-management instruments and the availability of in-bound trade credit. In this context, the three categories of company used in financial reporting and auditing

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[2] The case of BNY Corporate Trustee Services Ltd –v- Eurosail –UK-2007-3BL Plc & ors [2011] EWCA Civ 227 is relevant.
We are interested in the interpretation of the balance sheet insolvency test under section 123(2) Insolvency Act 1986. The Court of Appeal found that it applies to a company whose assets and liabilities (including contingent and future liabilities) are such that it has reached the "point of no return", the Master of the Rools adding “or in respect of which the shutters should be "put up", imprecise, judgement-based and fact-specific as such a test may be.” "I find it hard to discern any conceivable policy reason why a company should be at risk of being wound up simply because the aggregate value (however calculated) of its liabilities exceeds that of its assets. Many companies in that position are successful and creditworthy, and cannot in any way be characterised as unable to pay [their] debts".

of going concern has been useful in focusing directors attention on their obligations.

Question 4

Given the current measurement, recognition and disclosure requirements of International Financial Reporting Standards (IFRS), how effective are IFRS financial statements in enabling stakeholders to evaluate the robustness of the company's capital in the context of the going concern assessment? Are there any changes that could be made to these requirements that would better enable them to do so?

We do not think that accounting balance sheets are necessarily very helpful informing a going concern view. The past is not necessarily a good guide to the future.

More generally, we think that moves to bring the IFRS position on going concern more closely into line with that taken in the FRC guidance would be positive.

As regards measurement and recognition, we note that the issue of providing for expected as opposed to realised losses has been the subject of much discussion elsewhere and we would support some mild requirement for prudence to be introduced in this and other areas of reporting.

Company assessment of going concern and liquidity risk

Question 5

What processes are undertaken by directors in making their assessment of whether the company is a going concern when preparing annual and half-yearly financial statements?

- [Bullet points omitted for brevity.]

The pressures caused by the recent crisis and its ongoing effects have caused directors to pay much more attention to the issues of going concern and liquidity risk – and to financial strategy generally. That is not to say that the amount of attention is satisfactory in any case all that the level of attention will be maintained if (when) more normal circumstances prevail.

The attention to these questions was materially helped by the FRC's guidance of November 2008 and October 2009.

Sometimes boards will ask their audit or "finance" committees to do a lot of the work in considering going concern. This is satisfactory provided that appropriate information is provided to the board as a whole and sufficient time and attention is paid by the board as a whole.

While boards consider going concern in the context of the availability of liquidity for perhaps the forthcoming 18 months, we believe that a wider context is important.

Boards will normally have considered a coming year ahead when thinking about a budget and will have looked some years ahead in considering some sort of plan horizon. They will normally have considered the availability of funding as part of those discussions. Normally, the treasurer or the person carrying out the treasurer's role, perhaps the finance director, will have considered not only year-

end positions for the plan period, but also have estimated the maximum funding requirements within each plan year and have discussed this with the board[3]. Discussion of this is more poignant since the financial crisis.

Contingencies may make the consideration of these issues urgent and important for board at any time.

Most companies will have some kind of business model that drives these longer-term forecasts but it is important never to have too much faith in the projections of the model and a "common sense" review is always important.

Question 6

What is different about the review of going concern when raising capital compared to the annual going concern assessment undertaken for accounting purposes? Could some of the different procedures be used in the annual accounting or audit assessments?

Capital adequacy statements in prospectuses and shareholder circulars on major transactions tend to be far more formulaic. It should not be assumed that they are inherently superior to the processes around the regular going concern considerations.

Question 7

Does the company assess future cash flows and liquidity on a regular basis throughout the year? If so, how regularly is this done and is the information used any different to that used in the annual and half yearly assessment for the purpose of preparing financial statements?

We would expect the person carrying out the role of treasurer to assess cash flows and liquidity frequently and regularly throughout the year. This is an important part of managing the availability of funds and deployment of any temporary surplus funds.

Most companies will include some comment from the person carrying out the role of treasurer to be reported to the board at each meeting. Discussion of the subject is usually little or none at board meetings unless the particular contingencies of the company or of the economy in which it operates make it a particular concern. It is an important role of the board and particularly of non-executive directors to be sure that these considerations do not become complacent, formulaic and repetitive.

Question 8

To what extent and how do directors assess the viability of a company over the course of its natural business cycle?

If by "natural business cycle" it is meant the cycle of the particular business of the firm – acquisition, growth, decline, termination – other than companies set up for special purposes and with limited life, such as those for construction project

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[3] The person carrying out the treasurer's role will also, we would hope, have looked forward, perhaps in relatively back-of-the-envelope terms, for a full economic cycle and tried to form a view as part of formulating a financial strategy. Our experience is that boards are reluctant to consider projections that far ahead. This raises questions but not about the going concern issue.

completion, we are unaware of any company that considers this matter of the full cycle.

However, more relevant is the effect of the general economic cycle on the particular business of the company. This is usually only partly assessed by the board insofar as it is dealt with in the regular annual or longer cycle of business planning.

Companies with very long product cycles, for example production of airframes or aero engines, or with very long life assets, for example utilities, do look further ahead – not necessarily annually, but perhaps every two or three years.

This type of long-term planning is commonly more informal in smaller companies.

Question 9

The current model of disclosure identifies three categories company. What sorts of behaviours does this model drive? Is there a different model that might be useful? Would more guidance on the application of the current model be helpful?

The current model of disclosures seems to us to strike a good balance. It seems to have worked well. If a company has doubts about boundary-cases it triggers more disclosure, as is the intention. The guidance of October 2009, highlighting the legal and other obligations of directors has helped this process.

We believe it important that the FRC seek to secure regular publicity for the guidance even if the guidance remains unchanged for long periods.

Question 10

In your experience, what issues have resulted in a heightened focus on the assessment of going concern? What was the nature of the risks that gave rise to these circumstances? Had these risks being identified in advance, and if so how?

The fear of being hanged in the morning does concentrate the mind. The financial crisis and its consequential effects, particularly on the availability of bank debt, both by destruction of bank capital and through measures such as Basel III, have had a similar effect. Even companies in which risk of financial distress was remote have put questions of cash flow and liquidity management up their board agenda. It is the common experience of treasurers of large companies that they find it much easier to get items on the board agenda. And boards are more likely to want to hear directly from the treasurer much more regularly. More attention is paid to the likely attitude of credit rating agencies, debt investors and lenders and others contingently exposed to the company's credit.

We think that the guidance issued by the FRC ongoing concern issues has served to make the doubts and fears that a financial crisis produces more productive and guided orderly consideration of the issues. Given that even in periods of rapid growth, some companies may be prone to financial distress, the challenge for the FRC is to keep boards' attention to these issues year after year.

The auditor's approach to going concern and liquidity risk

Question 11

How does the auditor approach the assessment of going concern and liquidity risk? To what extent does this involve the testing the company's processes and

what other work is carried? Is there any specific reporting on the work done by the auditor ongoing concern and liquidity risk to Audit Committees? Does the assessment of going concern involve different processes in certain industry sectors? Are there different processes used where there is overseas reporting in addition to UK reporting?

The auditor will be familiar with the long-term planning and budget processes, with forecasting and, particularly, cash flow forecasting processes within the company. If a company is a group of companies the auditor will have an understanding of how the processes work within companies and produce the view of the consolidated group.

In a large company, all of the above processes will have been subject to some extent to review by internal audit or compliance departments. Otherwise, and in any case to some extent, auditors will carry out a reasonableness review on the processes.

The company will present appropriate forecasts to the auditors and to its executive and board to enable a going concern judgement to be made.

We believe that auditors will make input on their own processes to you.

Feedback on the Guidance for Directors of UK Companies in respect of going concern and liquidity risk

Question 12

Do you believe that amendments to the Guidance for Directors of UK Companies in respect of going concern and liquidity risk would be helpful? For example:

- *Guidance for directors and disclosures does not specify the language to be used, whereas auditors use more standardise wording. Is this helpful?*
- *Is there a need for a clear boundary between the three types of company?*

We believe that the Guidance is working well.

We think it is advantageous that auditors use more standardised wording. There is a need for clarity in the position taken by the auditors so that users of accounts are not confused or misled.

The circumstances of individual companies and the various contingencies that directors consider in forming a going concern view will differ enormously from company to company and time to time. It is important, of course, that the wording is not misleading or seeking to conceal by excessive disclosure. But we think it is vital that directors are able to choose their own wording subject of course to comment by their advisers – and ultimately by the Financial Reporting Review Panel and others.

Question 13

Are there any other views that you would like the Panel of Inquiry to take into account?

No.

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The Association of Corporate Treasurers

The Association of Corporate Treasurers (ACT) is the leading professional body for international treasury providing the widest scope of benchmark qualifications for those working in treasury, risk and corporate finance. Membership is by examination. We define standards, promote best practice and support continuing professional development. We are the professional voice of corporate treasury, representing our members.

Our 4,200 members work widely in companies of all sizes through industry, commerce and professional service firms.

For further information visit www.treasurers.org

Guidelines about our approach to policy and technical matters are available at http://www.treasurers.org/technical/manifesto.

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