

Implementing the recommendations of the Sharman Panel

A consultation on the revised Guidance on Going Concern and revised International Standards on Auditing (UK and Ireland) issued for comment by the Financial Reporting Council

Comments from ACCA to the Financial Reporting Council
30 April 2013

ACCA (the Association of Chartered Certified Accountants) is the global body for professional accountants. We aim to offer business-relevant, first-choice qualifications to people of application, ability and ambition around the world who seek a rewarding career in accountancy, finance and management.

We support our 154,000 members and 432,000 students throughout their careers, providing services through a network of 83 offices and centres. Our global infrastructure means that exams and support are delivered – and reputation and influence developed – at a local level, directly benefiting stakeholders wherever they are based, or plan to move to, in pursuit of new career opportunities.

www.accaglobal.com

Further information about ACCA's comments on the matters discussed here can be sent to:

Paul Moxey

Head of Corporate Governance and Risk Management, ACCA

Email: paul.moxey@accaglobal.com

ACCA welcomes the opportunity to comment on the revised Guidance on Going Concern and revised International Standards on Auditing (UK and Ireland) issued by the Financial Reporting Council.

SUMMARY

We support the recommendations of the Sharman Panel. However we are concerned that the draft guidance on going concern would be difficult to implement in practice, particularly for smaller companies.

Given that the guidance is written for 'all companies and their boards', rather than their advisors, the guidance would be clearer and more useful if it were based around implementing a set of good practice principles on going concern. A 'think small first' approach would be more appropriate, especially for SMEs and companies which do not have audit committees or risk committees. Supplementary guidance could then be provided (i) for companies that report on how they apply the principles and comply with the provisions of the UK Corporate Governance Code and (ii) for banks.

We believe that shareholders' primary interest in any going concern assessment is to be informed on whether or not the company is likely to be around for the next 12 months. We think this is also shareholders' main interest in reading board statements about internal control and risks. Following the banking crisis and other major risk events there is understandably more interest from shareholders and other stakeholders in risk and how it is managed. Risk identification and assessment are, however, more art than a science and we are concerned that expectations about what risk management can achieve are too high. It seems clear that

the boards of several banks had a false sense of assurance about the effectiveness of their own risk management procedures.

The report '*Roads to Ruin*' on behalf of Airmic by Cass Business School investigated the origins and impact of twenty major corporate crises between 2000 and 2009. The report highlighted the limitations of risk identification as presently practiced. Its recommendations included:

- The scope, purpose and practicalities of risk management will need to be rethought from board level downwards in order to capture risks, such as those we have identified, that are not identified by current techniques.
- Boards, and particularly Chairmen and NEDS, need to recognise the importance of risks that are not captured by current techniques.

We are concerned that false assurance may be given. The guidance on going concern should recognise the present day limitations of risk management in how it explains the practicalities of interpreting words and terms such as 'foreseeable' and 'high level of confidence'. The fact is that risks that are 'known unknowns' can be predicted (albeit with questionable accuracy) but risks that are 'unknown unknowns' obviously cannot be predicted. Good risk management procedures can of course reduce the number of significant unknown unknown risks but cannot eliminate them. There will always be uncertainty.

We suggest a visual representation of the steps that a board should take when considering going concern and matters such as what is in or outside the ordinary course of business and what to report. A flow chart would make the guidance easier to understand and follow. A flow chart

could also help simplify the mental gymnastics required to comprehend when the going concern basis of accounting might be used for a company which is considered not to be a going concern.

Finally, as going concern bears so strongly on the credibility of accounting information and the confidence that users are able to derive from it, it is important both to get this right and ensure that other countries adopt a similar basis. It would be unfortunate if UK companies found access to finance harder than non UK companies as a result of variations across countries in how to report on going concern. Given the scope for variation in meaning during translation and interpretation in practice, this is a further reason for keeping the guidance as simple as possible.

SPECIFIC COMMENTS

ACCA's response to the questions posed in the consultation

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

The twin stewardship and financial reporting purposes are set out clearly as they stand. That being said, it is not helpful for the passage relating to the stewardship purpose to use the term 'stewardship' interchangeably between directors and shareholders. We suggest it would be clearer for the passage concerned to read:

'to provide information to stakeholders about the company's economic and financial viability, thus helping to demonstrate the board's delivery of its stewardship and governance responsibilities and enabling shareholders to assess the financial position of the company with confidence and to hold the directors to account as necessary.'

The stated 'overarching purpose' of the assessment - 'to ensure that risks that would threaten the company's survival are properly identified and managed, respecting the interests of shareholders, creditors and other stakeholders' - is more wide ranging and demanding than either of the two reporting purposes. As stated in the general comments, the stated purpose is also unachievable. It is not possible for an assessment on these terms to 'ensure' that all risks that could threaten survival are identified and managed. We suggest that a more appropriate and focussed overarching purpose for the assessment would be to judge if a

company is a going concern in accordance with the requirements of Listing Rule 9.8.6R, as reproduced in the document, viz:

'...a company is judged to be a going concern if, for the foreseeable future, there is a high level of confidence that it will have the necessary liquid resources to meet its liabilities as they fall due and will be able to sustain its business model, strategy and operations and remain solvent, including in the face of reasonably predictable internally or externally-generated shocks.'

This definition is equally applicable to both purposes and to all companies, including SMEs. It is also a less demanding and more realistic purpose for boards and external auditors to consider.

Question 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 think it is appropriate to incorporate in the new test the term '*high level of confidence*'. This is because confidence is a highly subjective matter and because there will always be uncertainties that fall into the category of unknown unknowns, about which it is impossible to

have any justifiable degree of confidence. If a subjective term is to be used in the formulation, then we propose that it should be 'judgement'.

We would draw the FRC's attention to the proposal on *Confidence Accounting* that ACCA published in 2012 with CISI and Long Finance. The proposal sets out how accounts might better convey levels of confidence in numbers taking into account uncertainties which fall into the category of known unknowns. Pages 15 to 20 discuss how more meaningful assurances on going concern could be given, with particular reference to a major bank.

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

We broadly agree with the approach but consider the guidance could put this more succinctly. The table on page 8 of the draft Guidance is helpful but a flow chart could significantly improve comprehensibility.

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

We broadly agree with the approach but, again, we consider the guidance could put this more succinctly. For example it would be preferable to say that a company 'will remain solvent and liquid' than '*solvency and liquidity risks can be managed effectively*'. Shareholders

would be more interested in assurance on the former than the latter phrase.

The fact that 'foreseeable' means at least one year ahead from the approval of the financial statements should be set out more explicitly. We note that the 'look forward' period or foreseeable future for going concern remains significantly different between this guidance (12 months from approval) and IFRS (12 months from the balance sheet date).

We also think that the guidance should make an explicit statement there will always be events which cannot be foreseen. It is of course important that boards do their best to foresee things which can be foreseen but there will always be things which cannot.

Question 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 judgement and is not intended to be absolute? If not, why not and what changes should be made to the Guidance or the Code requirement?

This is a particularly difficult part of the guidance to understand. Many directors will struggle to reconcile the idea that a company could both be judged not to be a going concern and still be allowed to use the going

concern basis of accounting. We assume that this is what is meant by the words in paragraph 27:

'27. The corresponding threshold for departing from the going concern basis of accounting is a very high hurdle and may not be reached even when the company is not judged to be a going concern.'

Directors might be relieved that the going concern basis could be used but shareholders would be less happy. We would encourage the FRC to work with accounting standard setters to provide more clarity in this area.

Question 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?

We found the content of paragraphs 30 and 31 particularly difficult to follow and recommend that they be re-framed in more digestible terms. . This is an area where it would be particularly helpful to set out the guidance in the form of basic principles. A flow chart could help explain how to apply those principles.

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

Recommendation 2b says

(b) The FRC should seek to clarify the accounting and stewardship purposes of the going concern assessment and disclosure process and the related thresholds for such disclosures and the descriptions of a going concern in the Code (and related guidance for directors and auditors) and in FRS 18 and ISA (UK & Ireland) 570, if possible in line with such international consensus

We think the two purposes are quite compatible with the requirement of Listing Rule 9.8.6R. The draft Guidance has complicated this by seeking to widen the assessment from covering risks to liquidity and solvency to all risks.

Question 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 significant 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?

Recommendation 3 says

The Panel recommends that the FRC should review the Guidance for Directors to ensure that the going concern assessment is integrated with the directors' business planning and risk management processes and:

(a) includes a focus on both solvency and liquidity risks, whatever the business. In relation to solvency risks, this should include identifying risks to the entity's business model or capital adequacy that could threaten its survival, over a period that has regard to the likely evolution of those

risks given the current position in the economic cycle and the dynamics of its own business cycles;

(b) may be more qualitative and longer term in outlook in relation to solvency risk than in relation to liquidity risk; and

(c) includes stress tests both in relation to solvency and liquidity risks that are undertaken with an appropriate level of prudence. Special consideration should be given to the impact of risks that could cause significant damage to stakeholders, bearing in mind the directors' duties and responsibilities under the Companies Act 2006.

In our view, Section 2 goes well beyond what is required by the recommendation. Rather than integrating the going concern assessment with the business planning and risk management processes, the guidance seems to seek to drive the risk management process and effectively replace the Turnbull Guidance on risk management and internal control.

The Guidance is in some respects highly and unnecessarily prescriptive. Paragraph 3 might start better by saying that the board 'should not take risks which could significantly threaten the company's ability to remain a going concern if breakup would mean a deficiency of assets'. Boards of SMEs in particular might struggle with the term 'stress tests'. The remainder of the guidance could better be expressed as a set of principles. Section 3 could then give guidance about applying principles in language which would be relevant to small as well as large companies.

Question 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?

The Panel's Recommendation 4 suggests, inter alia, that disclosures about going concern risks should be integrated with the Effective Company Stewardship proposals to seek to ensure that

- (a) the discussion of strategy and principal risks always includes, in the context of that discussion, the directors' going concern statement and how they arrived at it; and
- (b) the audit committee report illustrates the effectiveness of the process undertaken by the directors to evaluate going concern by:
 - i. confirming that a robust risk assessment has been made; and
 - ii. commenting on or cross-referring to information on the material risks to going concern which have been considered and, where applicable, how they have been addressed.

This is a challenging recommendation to implement in the Guidance.

Part (a) above is relevant to all companies but part (b) would seem to be aimed at large companies with audit committees and particularly those that report in accordance with the UK Corporate Governance Code.

Section 3 of the guidance seems to have been written for such companies and is clearly inappropriate for SMEs. It is also doubtful if it is suited to listed companies with small boards as such companies might find it unnecessary to have both an audit committee and a risk committee.

The concept of going concern is, however, important for all companies so the guidance on assurance should be relevant to all companies. We recommend that this section be rewritten in the form of principles. A separate section could be included that deals with companies with sub committees of the board.

Question 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 proposed amendments to the auditing standards adequately implement the enhanced role of the auditor as envisaged in the Consultation Paper. As we consider that the guidance needs revision, however, we do not comment in detail on the proposed amendments as they would have to reflect any revisions made.

Question 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?

Any disclosure of material uncertainties (Section 4 6b) or that the going concern basis is not appropriate (Section 4 6c) would signal the demise of

that bank and possibly also wider the banking system. The government's ability to support the banking system has been weakened by the support already given and the economic slump which has followed. It is now questionable whether a central bank would be able to rescue a major insolvent bank.

It is important to recognise that such disclosures represent a 'nuclear option' and could never be made, which means that any discussion about the situation must be hypothetical.

In theory though, we consider that if a bank is dependent on central bank support to maintain a short term liquidity shortage and that the central bank has committed to providing such support there should be no need to disclose a material uncertainty. It would be different if there is doubt about either the central bank's willingness to give support (eg in the case of Northern Rock) or if there is uncertainty about the bank's solvency (eg in the case of HBOS).

Question 12: Do you consider the proposed implementation date to be appropriate? If not, why not and what date should the application date be?

We think that substantial revision will be required. 1 October would be too soon.

Question 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?

No. We think the guidance is unnecessarily elaborate and therefore capable of a wide range of interpretations. People will be confused as to how to implement it and there is a risk that false assurance will be given to stakeholders. We are also concerned that, when the next company failure occurs, the present guidance is sufficiently complex to provide a smoke screen for any negligent party to claim that they had complied. It would be difficult for any panel or court of inquiry to refute such a claim.

Question 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?

As discussed above, although the going concern concept is as relevant to SMEs as it is to larger companies, the guidance is wholly inappropriate for SMEs. Terms such as stewardship, audit committee and risk committee are unhelpful. The guidance is also too elaborate. It would be preferable from the point of view of the boards of all companies for the guidance to be based around a set of principles that would be applicable to all companies.