UNIVERSITY OF BIRMINGHAM

The Birmingham Business School

28 April 2013

Marek Grabowski
Director of Audit Policy
Financial Reporting Council
5th Floor, Aldwych House
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Dear Mr Grabowski

Implementing the Recommendations of the Sharman Panel: Revised Guidance on Going Concern and revised International Standards on Auditing (UK and Ireland)

The Accounting Research Group at the Birmingham Business School is delighted to comment on the Financial Reporting Councils (the FRC) Revised Guidance on Going Concern and revised International Standards on Auditing (UK and Ireland) (the Guidance).

We have considered the Sharman Inquiry's final report and recommendations, and the Guidance issued by the FRC in our response.

Generally, we are supportive of the proposed amendments which will give users clearer information on the going concern risks facing a company and the action taken by the board to mitigate those risks.

Our thoughts on the specific questions posed in the Guidance can be found in appendix 1 to this letter.

If you have any questions or queries on our response, please do not hesitate to contact Lucy Dilley (L.Dilley@bham.ac.uk or +44(0)121 414 2273) who will be happy to assist.

Yours sincerely

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Appendix 1: Response to questions posed in the Revised Guidance

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 is appropriate? If not, why not and what changes should be made to the Guidance?

We agree that two purposes of going concern reporting have been clarified through the Guidance. This document is aimed at Directors and Audit committees.

The Sharman Inquiry recommended that the two going concern purposes be clarified for both Directors and Auditors. Currently it appears as though there is no clarification included within the revised International Standards on Auditing (UK and Ireland). Consideration could be given as to whether the same clarification could be included within ISA 570 Going concern. If it were to be included, the statement could then be linked to the Auditors' responsibilities in relation to each of the going concern purposes, making it clear to auditors exactly what their roles and responsibilities are in relation to going concern. This additional guidance would result in further disparity (which should be minimised) between ISAs (UK and Ireland) and International Standards on Auditing. Although we do support the additional focus on stewardship, the FRC may seek to address this point following consultation with the IAASB.

Question 2:

Do you agree with the description in the Guidance of when a company should be judged 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 agree with the description of when a company should be judged a going concern and that when a going concern assessment is made, a full account of all actions whether within or outside the normal course of business should be considered. We concur with this view, as the Shareholders' and Stakeholders' priority in relation to going concern is whether a company can remain a going concern irrespective of whether any actions are within or outside the normal course of business. This should not preclude the need to disclose within Annual Report those actions that could be taken outside the normal course of business as this would add further important qualitative going concern information. We also concur that the Board should have a high level of confidence that any mitigating actions taken to address identified going concern risks would be effective.

Whilst we accept this assessment will require a certain level of judgement, the use of the phrase 'high level of confidence' introduces additional subjectivity due to the potential varying interpretation of 'high level' and 'confidence' by different parties given neither are linked to a mathematical likelihood. We believe the term 'high level of confidence' would benefit from a clear definition to ensure all preparers of financial statements clearly understand what is meant by the term. When drafting this definition, we don't believe a bright-line rule should be specified as it is important that users of the accounts are able to rely on the integrity and professional judgement of both Auditors and Boards of Directors

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?

As noted in our answer to Question 2, we concur that a full account of all actions whether within or outside the normal course of business should be taken when assessing whether or not a company is a going concern.

We also agree with the approach that mitigating actions that are outside the normal course of business may be an indicator of severe distress (although this too is subject to professional judgement).

We agree that through the use of examples the guidance clearly illustrates what could be classed as actions outside the normal course of business.

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?

Generally we agree with the approach taken to interpret the term 'foreseeable future', but we have some observations. The Guidance stipulates that the generally accepted minimum period for the assessment of detailed budgets and/or forecasts is 12 months from the date of approval of the financial statements. The guidance also notes that the board is equipped to develop a high level of confidence that solvency and liquidity risks can be managed effectively during at least that period. Finally the Guidance goes on to say that 'when considering solvency, boards address longer periods through the general economic cycle and specific business cycles. The length of the period considered is a matter of judgement and will depend on the nature of the company's business, its business cycles, the life cycles of its assets, the stage of the general economic cycle at the time of the assessment and the quality of the data available to make the assessment'.

Firstly, from the Guidance, it is not clear when we are talking about the foreseeable future, whether we are speaking specifically around going concern disclosures or whether we are considering if the accounts should be prepared on the going concern basis. This is made a little clearer in appendix 1 to the Guidance but it may be worth making the distinction clearer in the main body of the text. This could be achieved by adding some explicit statements to the Guidance explaining that the company's liquidity and solvency should be considered for at least 12 months from the financial statement approval date when considering whether the accounts should be prepared on the going concern basis, but for narrative reporting purposes the period should be extended to longer periods (general economic cycle and business cycle).

Secondly, business and economic cycle are not defined within the Guidance. Although there is a general understanding of what each of these terms mean, the Guidance may benefit from a definition to minimise variation on application between companies.

Finally, throughout the Guidance, it is clear there are different uses for the term going concern, which may cause confusion for users of the accounts. We would therefore suggest enhanced disclosures are presented in the annual report describing the different uses of the term to enable users to draw their own conclusions.

Question 5:

Do you agree that 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 '<u>is</u> a going concern' and from its use in the accounting and auditing standards is 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 Code requirement?

In addition to our comments below, please see our response to Question 4.

Appendix 2 to the Guidance provides an explanation as to the different regulatory requirements in relation to going concern. The main text of the Guidance comments on the key elements of going concern reporting. Neither section is cross-referred to the other. Although this is the case, there is no clear explanation that the requirements and meaning of going concern are distinct and can vary depending on whether you are referring to the going concern principle, narrative reporting, going concern in the context of material uncertainties, going concern in the context of accounting and auditing standards and the directors' requirements in each circumstance. The Guidance may benefit from some narrative or diagram describing each of the purposes and the Directors' and Audit Committees' responsibilities in relation to each term. This information could then be linked to the two going concern purposes.

We agree that it is made clear within the Guidance that the assessment of going concern is a judgement.

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 concur with the view taken in the Guidance in relation to this question.

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 on those standards?

The Guidance on going concern is in our opinion consistent with the Guidance included within FRS 18 and with ISA (UK and Ireland) 570.

Question 8:

Do you agree that section 2 of the Guidance appropriately implements Recommendation 3? Do you agree with the approaches to stress tests and the application of prudence in conducting them? Do you agree with the approach to identifying significant solvency and liquidity risks? If not, why not and what changes should be made to the Guidance?

We concur with the approach the Guidance has taken in relation to the implementation of the Sharman panels' third recommendation.

Generally we agree with the approach to stress tests. We concur that these tests should be conducted on a prudent basis, as this is likely to allow the identification of issues quickly. Despite this we would like to highlight that the IASB is moving away from the concept of prudence and towards neutrality. This may result in a mismatch between the Guidance and accounting standards in the future. This is something the FRC should consider discussing with the IASB. Additionally, the FRC could consider asking Auditors to comment on the suitability of the stress tests performed by management within their Audit Report. This may reduce the frequency of inappropriate stress tests being conducted.

Finally, we agree with the approach taken to identify significant solvency and liquidity risks and we agree the description provided in the guidance is sufficient.

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?

We broadly agree that the approach taken in section 4 of the Guidance implements the fourth recommendation of the Sharman Panel.

We note however that the Sharman panel recommended that the Audit Committee make certain statements in relation to the effectiveness of the process undertaken by the Directors to evaluate going concern. Presently the suggested Guidance relies on management, rather than Audit Committee to make these comments.

We believe the term 'Robustness of the going concern assessment process' is a phrase which is easy to understand, and provided the Guidance is followed, the assessment completed by management should be sufficiently robust. To ensure this is the case, the FRC could consider adding narrative within the Guidance that suggests a robust going concern assessment process is expected to include, as a minimum, all elements of the Guidance.

Question 10:

Do you agree that the proposed amendments to 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 auditing standards?

We concur that the proposed amendments to the auditing standards implement the enhanced role of the auditor.

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?

We concur with the approach taken and have nothing to add.

Question 12:

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

The suggested implementation date could be perceived as too soon given that if the Guidance is released by 30 June 2013, it will be applicable for 30 June 2013 interim financial statements. This issue could be perceived to exist since there is a requirement to embed the going concern review process within the company's business planning processes, risk management framework and internal controls to adhere to the guidelines. This could mean companies may have to introduce new controls and processes which will give December year end companies very little time to implement the Guidance. We would suggest the Guidance apply to periods commencing on or after 1 March 2013 to allow sufficient implementation time.

Question 13:

Do you believe the Guidance will deliver the intended benefits? If not, why not? Do you believe that the Guidance will give rise to additional costs or inappropriate consequences? For example, as compared with the 2009 Guidance, do you believe that the Guidance will give rise to fewer companies being judged as a going concern and/or more companies disclosing material uncertainties? If so what are the key drivers and can you give an estimate or nomination of the likely cost or impact? Do you believe that such additional costs or impact would be justified by benefits?

We agree that the Guidance should deliver the intended benefits and we don't believe it will give rise to additional costs or inappropriate consequences.

Finally we don't believe it will result in fewer companies being judged a going concern. We do however believe that the increased narrative disclosures made by the Board will allow Stakeholders to contrast and compare where different auditors perceive the emphasis of matter reporting threshold to lie. The FRC should consider whether detailed auditor guidance on the inclusion of going concern emphasis of matter paragraphs in annual reports is required to minimise any disparity between audit firms.

Question 14:

Do you agree with the approach to SMEs in this Guidance? If not, why not and what changes should be made to the Guidance?

We concur with the approach to SMEs in the Guidance.

Question 15:

Are there any other matters which the FRC should consider in relation to the Guidance and the support? If so, what are they and what changes, if any, should be made to address them?

In our view there are no other matters the FRC should consider.