

23 April 2013

For the attention of Marek Grabowski
Director of Audit Policy
Financial Reporting Council
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Dear Sirs

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

We respond to your consultation paper on the above topic and have addressed the specific questions posed in the consultation paper in turn below, however, we have some overall observations and concerns.

To say that we are disappointed in the contents of the Paper would be a gross understatement. The recommendations, as drafted, appear to be ill thought through and risk having disastrous commercial effects. They have also, in our opinion, been applied disproportionately to the SMEs that form the bedrock of the UK economy.

The net result of the guidance, in our view, will be a significant increase in the number of financial statements subject to emphases of matter over going concern; indeed, because of the increased level of confidence that the guidance appears to require, they may even become the norm. This is because the draft Guidance appears to take the view that material uncertainties exist in any situation where the 'high level of confidence' envisaged in the draft Guidance cannot be obtained. At a time where the economy is still troubled, and against a background of wider issues at EU level, the proposals risk being highly damaging to businesses, because it is simply impossible for most businesses to obtain assurance from their lenders that funding will continue with the 'high level of confidence' which appears to be required.

Indeed, it is possible to envisage two equally unwelcome adverse consequences from the implementation of the draft Guidance; either more businesses will suffer (and even fail) as a result of the perception (or misperception) that they are not a going concern, or emphases of matter will become the norm and therefore entirely lose their raison d'être of highlighting genuinely significant matters to be brought to the attention of the users of the financial statements.

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Moreover, it appears the proposals are being rushed through with little or no time for proper consideration and implementation. It will simply be impossible for many businesses to implement them properly in the time allowed particularly as the FRC has steered clear of providing any examples of how the draft Guidance should be applied, leaving businesses in the dark on what might (or might not) comply and therefore leaving them (and their auditors) at risk of censure.

They also run counter to the principles of deregulation for small businesses which the Government has been keen to implement, instead heaping more compliance burdens on such businesses with no benefit that we can see either to the companies, their shareholders, the wider economy or even the public good. The application of the draft Guidance in full to all companies, including SMEs, is both disproportionate and fundamentally unfair. Moreover, the format of financial reporting for smaller entities is currently up in the air due to deliberations on this topic at EU level and it appears premature (to say the least) to impose any additional requirements on small companies at this stage, particularly as the EU proposals will actually preclude the imposition of additional requirements in a particular jurisdiction.

Whilst we can understand that the FRC may wish to appear a thought leader in the area of enhanced reporting, we do not believe that ill thought out proposals such as this are the way to go about it. Moreover, there is no guarantee whatsoever that other jurisdictions would follow suit. The UK therefore risks being out of step with wider international guidance in this area; indeed the UK is already more stringent in determining what is considered the foreseeable future than other jurisdictions (applying twelve months from the date of approval of the financial statements in the UK and Ireland version of the ISAs, compared to twelve months from the balance sheet date in the non-UK version) and there seems to us to be no benefit whatsoever in widening the gap between the UK and non-UK versions of the ISAs further in this respect.

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?

We entirely disagree that the draft Guidance provides the clarification recommended by the Panel. Indeed the Guidance, as drafted, appears to require a far higher level of confidence about the entity's ability to continue as a going concern than is currently the case. A 'high level of confidence' as applied in the draft Guidance is not the same thing as 'will continue in operational existence' or 'realise its assets and discharge its liabilities in the normal course of business' as the relevant Standards currently envisage.

Rather, a requirement for a 'high level of confidence about the entity's solvency and liquidity for the foreseeable future' raises the bar to such an extent that for many businesses this will be impossible to achieve in practice, given factors such as the increasingly short term nature of bank funding, order books and similar factors. As noted above this will significantly increase the number of companies subject to going concern disclosures and emphasis of matter paragraphs; indeed rather than providing clarity this may well simply drown the users of the accounts in detail. Moreover, it is surely not necessary for a 'high level of confidence' to be present; the absence of 'significant uncertainty' over the appropriateness of the going concern basis has historically been enough to avoid an emphasis of matter paragraph and there does not seem to be any compelling reason to change this.

- 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?**

As noted above we believe it is quite simply impossible for the directors of many entities to have a 'high level of confidence' in this respect. It is not practical in the context of the current economic climate and the decisions that lenders are taking (for instance, unwillingness to commit to renewal of facilities on even a twelve month basis).

In determining whether a company is a going concern, we would argue that directors already take into account all relevant facts and circumstances; this includes the actions that they might reasonably need to take to ensure the business' survival for a period of at least twelve months from the date of approval of the financial statements. This will include not only the course of action that they expect to take, but also contingency plans – whether these are inside or outside the 'normal course of business'. This is simply common sense.

The draft Guidance also muddies the waters in respect of the 'foreseeable future'. At present, this is defined, as noted above, as a period of at least twelve months from the date of signature of the audit report. This is a concept which is well understood by companies and their auditors. Under the draft Guidance as we have interpreted it, the 'foreseeable future' becomes a more elastic – and potentially longer – period which is linked to the business cycle. It is hard enough for companies to predict with any degree of certainty what will happen in the next twelve months and when extended to a longer period, it will simply be impossible for companies – in the absence of a functioning crystal ball – to obtain the 'high level of confidence' over that period that the Guidance appears to expect. To raise the bar to this level would therefore, in our opinion, be entirely inappropriate.

- 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 are not convinced that it necessarily matters whether actions that may or may not be taken by a company when assessing the appropriateness of the going concern basis are inside, or outside, the normal course of business; surely what matters is that there is not a 'significant uncertainty' over the appropriateness of the going concern basis and that sufficient disclosures are made in the financial statements that the users of the accounts can understand the various factors which the directors have considered when making that assessment. A successful 'rescue package' may be outside the normal course of business but have the end result that a significant uncertainty does not exist. The guidance given in the table in section 2.14 of the Guidance is quite simplistic and in particular it is difficult to view renegotiating covenants to avoid a breach as 'outside the normal course of business' – for many entities this has simply been a necessary course of action in difficult economic conditions.

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?

As should be clear from our comments in the above sections, we do not agree with the approach taken to interpreting the foreseeable future and can see no compelling reason for diverging from the current approach.

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?

Clearly, because it requires looking into the future, determining whether or not a business is a going concern is an exercise in judgement, in the absence of a crystal ball. It cannot be absolute by its very nature, whether or not the company is subject to the Code, and in our view this is obvious to the users of financial statements.

It is very rare that financial statements are prepared on a basis other than the going concern basis – this is only the case when the directors have either taken a decision to liquidate or cease trading or have no realistic alternative but to do so and is an entirely different scenario from a set of accounts which are subject to an emphasis of matter paragraph due to the existence of a significant uncertainty but are prepared on the going concern basis. In this scenario going concern issues are a potential problem which the company is attempting to deal with, rather than certainty that the situation is terminal.

As it stands, the Guidance does not add clarity and potentially just muddies the waters further when requiring the 'high level of confidence' because of the inevitable increases in the number of emphasis of matter paragraphs that we believe will result.

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 do not believe that the approach to determining when there are material uncertainties is appropriate. Whilst quite clearly judgement will need to be exercised in determining whether material uncertainties need to be disclosed – as is the case at present - paragraph 2.31 in particular appears to require there to be disclosures of material uncertainties in *any* situation where a 'high level of confidence' is unable to be obtained and therefore will lead to the proliferation of emphasis of matter paragraphs which we have referred to throughout.

We also dispute whether any informed user of a set of financial statements truly interprets an absence of any mention of material uncertainties in an annual report as 'effectively guaranteeing a company's survival for the next 12 months'. Whilst we would agree that it is equally inappropriate to regard a mention of material uncertainty as 'a portent of imminent collapse' it is much more likely that the user of financial statements will interpret the inclusion of such items (rightly or wrongly) as indicating that something is amiss.

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?

We do not believe that the interpretations in the Guidance are in accordance with Recommendation 2 (b). This recommendation proposed that the FRC seek to clarify the accounting and stewardship purposes of the going concern assessment and disclosure process in the Code, and the above referred to accounting and auditing standards, if possible in line with such international consensus. The FRC appears to have completely disregarded the 'if possible in line with such international consensus' part of the recommendation in favour of redefining when going concern disclosures and reporting are, or are not, required, instead proposing a far more stringent approach than is the case in either international accounting or auditing standards; as noted above the UK was already more stringent in the case of the latter.

As noted above, whilst we understand that the FRC wishes to be seen as a thought leader in this area, we do not believe that this Paper will have that effect, or that it will be effective in producing an international consensus, if anything quite the reverse.

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?

We do not agree with the approach in the draft Guidance in these areas particularly in the absence of practical guidance. It will be particularly difficult for SMEs to apply the draft Guidance as currently drafted and we believe a more proportionate – and clearer - approach is required. Indeed, this should be the case throughout the Guidance.

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?

Again, we do not believe that the approach taken in the draft Guidance is appropriate and we do not believe that the 'foreseeable future' should be re-interpreted in the way envisaged in the Guidance. We are also concerned at the use of the term 'robustness' alongside the requirement for

a 'high level of confidence' as this simply reinforces the impression that an extremely high level of assurance over going concern is required to avoid any emphasis in the audit report.

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?

We believe that it is entirely inappropriate for the FRC to seek to move the ISAs (UK and Ireland) unilaterally further away from the ISAs as drafted by the IAASB. As noted above, the UK already enforces more stringent requirements in this area and the case for even more stringent requirements has, in our view, simply not been made. Consensus should be sought before making any such unilateral changes to the Standards and in our view the Guidance should focus on working with the existing Standards rather than forcibly seeking to change them.

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?

Whilst we agree with this approach, we think that it is inconsistent with the guidance for other entities. As noted elsewhere the requirement for a 'high level of confidence' for a potentially expanded 'foreseeable future' will vastly increase the number of emphases of matter paragraphs required and in this context the guidance appears to give banks an opt-out which is not available to other entities. In our view, it would be far better for more proportionate guidance to be applied across the board.

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

We consider the proposed implementation date to be totally inappropriate. At present, the Guidance is in draft form and once the consultation period has ended the FRC will need to consider the comments made and then redraft the Guidance before putting it into final form. To apply the Guidance for accounting periods beginning on or after 1 October 2012 is quite simply far too soon, and for any entities with a September 2013 year end – or indeed any entities with a December 2013 year end that are required to produce half year reports – it is clearly impossible for it to be applied properly in the time allowed, even if the Guidance as currently drafted were to be finalised in its current form. There is simply not enough time for the draft Guidance and its effects to be properly analysed by companies and their professional advisers and for the practical implications to be considered. It is also impossible to see how any entities could adopt early as is 'encouraged' by the FRC in the Preface to the draft Guidance.

Indeed, the proposed implementation date suggests that the proposals are being rushed through with little time for analysing the comments received and taking them into account, which is surely

not the impression that the FRC wishes to give. Consultation on a matter as important and wide ranging as this cannot simply be treated as a formality.

In our view the Guidance needs to be completely re-written in the light of the comments received, and then re-exposed for further comment with an effective date that allows for proper, considered implementation of its requirements. We also believe that any application to SMEs should be shelved pending the EU deliberations on financial reporting for small and micro entities referred to in our introductory comments. It would be far better either to delay the Guidance entirely until the direction of travel in this area is clear, or if the FRC is determined to press on regardless of these factors, to limit its scope to entities subject to the Code.

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 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 should be clear from the remainder of this letter, we do not believe that the Guidance will deliver the intended benefits, indeed we would argue that it will deliver no benefits whatsoever and have significant unintended consequences. As stated elsewhere we believe that the number of emphasis of matter paragraphs will increase significantly because it will be impossible for many, even most, businesses to be able to express the 'high level of confidence' required by the draft Guidance; as noted in our introductory remarks this will have the effect either that companies will face increased commercial issues, including availability of finance, which are potentially completely unjustified, or the emphasis of matter paragraph will simply become boiler-plate disclosure, neither of which is an appropriate outcome.

We also believe that where companies are entitled to take exemption from audit – small companies and those subsidiary undertakings where the parent company has guaranteed their liabilities – they will become far more likely to do so as a result of the introduction of this Guidance. If a small company has the choice between an audit report subject to an emphasis of matter paragraph, or a 'clean' accountant's report on unaudited financial statements, they are highly likely to choose the latter, regardless of the benefits the assurance provided by an audit can bring. In the context of the Competition Commission's investigation into the larger end of the audit market and the general wish to promote competition in the audit market it is difficult to see why the FRC wishes to place yet another obstacle in the way of providing audit services.

Finally, we would note that no impact assessment has been performed. Given the potentially serious consequences the draft Guidance could have, we would urge the FRC to conduct a thorough, in depth impact assessment before any attempt is made to finalise the Guidance.

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 that the draft Guidance is completely disproportionate to SMEs and would be onerous for them to apply as well as having significant commercial effects for them as a result of the

plethora of additional emphasis of matter paragraphs that would result from the application of the draft Guidance. It is simply not acceptable for specific considerations for SMEs to be reduced to what amounts to a footnote to section 2 of the draft Guidance, namely the four paragraphs 35-38, each of which consists of less than five lines.

We believe either that an approach similar to the 2009 Guidance should be taken, where the requirements were initially considered from the perspective of SMEs and then additional requirements specified for larger companies, or that the Guidance should not be applied to SMEs at all, but rather restricted only to those entities subject to the Code where the (actual or perceived) systemic risk is greatest.

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?

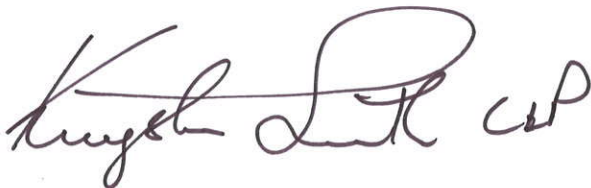
We have addressed those matters which we believe the FRC should consider as necessary in our responses to the above questions and in our introductory remarks.

As should be evident, we believe that to rush through the Guidance in its current form would not only be disproportionate, but potentially disastrous, and would also risk putting UK businesses at a disadvantage compared to businesses in other jurisdictions subject to less stringent reporting requirements.

We urge the FRC to consider all the comments received from this consultation – from all stakeholders including listed companies, SMEs, and audit firms of all sizes – when determining the next steps in this area and to think very carefully before progressing with the Guidance in anything resembling its current form. As an absolute minimum, the Guidance needs to be completely redrafted and its scope considered very carefully, together with its unintended consequences and potential wider commercial effects.

If you have any questions on the contents of this letter, then please contact either Sir Michael Snyder or Tessa Park.

Yours faithfully



Kingston Smith LLP