Consultation Paper

FRC Financial Reporting Council

January 2013

Implementing the Recommendations of the Sharman Panel

Revised Guidance on Going Concern and revised International Standards on Auditing (UK and Ireland)

The FRC is responsible for promoting high quality corporate governance and reporting to foster investment. We set the UK Corporate Governance and Stewardship Codes as well as UK standards for accounting, auditing and actuarial work. We represent UK interests in international standard-setting. We also monitor and take action to promote the quality of corporate reporting and auditing. We operate independent disciplinary arrangements for accountants and actuaries; and oversee the regulatory activities of the accountancy and actuarial professional bodies.

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Section 1 – Introduction

The Sharman Panel was commissioned in March 2011 to examine the particular challenges faced by directors, management and auditors where companies face going concern and liquidity risks and to consider how such challenges should be addressed in the future. The financial crisis highlights the importance of the identification, analysis and management of risk, not only in financial services. Questions have been raised about the quality of information provided on companies' financial health and their ability to withstand economic and financial stresses in the short, medium and longer term.

The FRC's proposals for implementing Recommendations 2(b), 3, 4 and 5(a) of the Sharman Panel of Inquiry, published in June 2012[1] are addressed by the proposed *Guidance on Going Concern 2013* ('Guidance') and *Supplement for Banks* and the proposed amendments to the International Standards on Auditing (UK and Ireland) ('ISAs (UK&I)') included in this consultation document. The status of implementation of the other Panel recommendations is summarised in the Appendix.

Purpose of this Consultation Document

The Financial Reporting Council (FRC) is seeking the views of stakeholders to determine whether the proposed new Guidance and Supplement and the proposed revised auditing standards are appropriate and practical.

The FRC complies, where possible, with best practice for consultations and has therefore set a three month period ending on 28 April 2013. The FRC will evaluate all comments received with a view to issuing the updated Guidance and related ISAs (UK and Ireland) by 30 June 2013 for implementation for financial years beginning on or after 1 October 2012 with earlier adoption encouraged.

How to respond

The FRC welcomes comments from interested parties on the exposure draft by 28 April 2013. Comments, preferably in an electronic form that facilitates "copy and paste", may be sent by e-mail to m.grabowski@frc.org.uk. If this is not possible, please send written comment to:

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[1] The Panel's final recommendations are reproduced at Appendix 1.

Section 2 – Explanation of Changes and Consultation Questions
Proposed Revised Guidance and Changes to the Auditing Standards

This section explains how the Panel's recommendations that are being addressed in this consultation document (Recommendations 2(b), 3, 4 and 5(a)) are proposed to be implemented and sets out related consultation questions. The proposed Guidance and changes to the auditing standards are included in Sections 3 and 4 of this consultation document. Cross references in this section to them, and to the reports and the recommendations of the Panel, adopt the conventions set out in the footnote[2].

Panel Recommendation 2(b)

The Panel recommends that:

(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; …

Clarifying the purposes of the going concern assessment and reporting

The Guidance sets out both the overarching purpose of the assessment (1.3):

"The overarching purpose of the going concern assessment is 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."

and the two purposes of going concern reporting (1.4):

"There are two purposes of going concern reporting:

(a) Stewardship purpose – to provide information to stakeholders about the company's economic and financial viability, helping to demonstrate the board's stewardship and governance and encouraging shareholders to perform their own stewardship role by engaging in appropriate dialogue with the board and holding the directors to account as necessary.

(b) Financial reporting purpose – to establish and disclose the information about going concern needed for the financial statements to give a true and fair view."

The Panel's views on the purposes are set out in its final report (FR CL3 and 1, 5, 6 and 89-92).

***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?**

[2] References to the preliminary and final reports of the Panel are preceded by the letters PR or FR respectively followed by the paragraph number(s). References to the final recommendations of the Panel are given as: Rec # (where # is the recommendation number). References to the proposed Interim Guidance are given as: N.#, (where N is the Section number and # is the paragraph number – the Section number for the Covering Letter or an Appendix is given respectively as CL or Ax, where x is the Appendix number). References to the auditing standards are given by Standard and paragraph number.

Determining when a company should be judged to be a going concern

The Guidance sets out the circumstances in which a company should be judged to be a going concern for the purposes of the statement made by the directors that the company is a going concern, in accordance with Code Provision C.1.3 and Listing Rule 9.8.6R (1.12):

'… 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.'

The Panel explored the description of a going concern in the accounting and auditing standards (FR 82-88). It pointed out that each of these envisages that the company will continue in operational existence. In addition, the auditing standards (ISA 570) envisage that it will be able to realise its assets and discharge its liabilities in the normal courses of business and highlight a number of examples where the onset of actions outside the normal course of business may indicate that there is a material uncertainty (FR 82).

The IFRS Conceptual Framework envisages that there is "neither the intention nor the need to….curtail materially its operations". The Code does not include a definition of a going concern.

The Panel concluded that there is considerable scope for differing interpretations as to when a company should be judged to be a going concern and suggested that the FRC should consider the extent to which a company should be judged to be a going concern, when there is no realistic alternative but to take actions outside the normal course of business (FR 83 to 87).

This has therefore been considered further in developing the interpretation in the Guidance. The conclusion drawn was that it might be appropriate to judge a company to be a going concern, even if it has no realistic alternative but to take actions outside the normal course of business in order to survive, depending on the likelihood of effectiveness of those actions. It follows from this conclusion that even a company that has no realistic alternative but to take such actions may be able to survive by taking such actions.

The primary going concern issue is whether the significant solvency and liquidity risks would threaten its survival. The conclusion drawn is that those risks should not be judged to do so if the board can develop a high level of confidence that, if those risks were to crystallise, actions (whether within or outside the normal course of business) will be available to it that will be effective in addressing those risks. Conversely, those risks should be judged to threaten the company's survival if the board is not able to develop that level of confidence about the availability and effectiveness of mitigating actions.

A high level of confidence is not an absolute level of confidence. Even though there may be a high level of confidence that the company would survive, the likelihood and impact of failure or the impact of severe mitigating actions may necessitate disclosure of material uncertainties (see below).

Therefore, the Guidance reflects the conclusion that the key factors that should be taken into account in making the judgement as to whether the company is a going concern should include the following:

- As recommended by the Panel, both **solvency and liquidity should be considered**. Accordingly, the Guidance applies both a solvency and a liquidity criterion in making the judgement;
- Whether an entity is a going concern is a matter of **judgement not fact**. This is reflected in the use of the words "is judged to be a going concern";

- The judgement depends on the **foreseeable future** over which the board considers the evolution of risks and, even over that period, the **inherent ability to predict** future events. References to the 'foreseeable future' (see further discussion below) and to 'reasonably predictable… shocks' address these matters.
- When the Company faces risks to its solvency or liquidity of such significance that they would threaten its survival the board should be able to obtain **a high level of confidence** that, if those risks were to crystallise, effective mitigating actions (whether within or outside the ordinary course of business) will be available to the board. Therefore the board should make its judgement taking full account of all mitigating actions that they would take to address such risks and that would be available to them (2.10).

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?***

The implications and nature of actions within and outside the normal course of business

The intention or need to take actions outside the normal course of business is, however, likely to indicate severe levels of distress. The Guidance therefore suggests that the onset of that intention or need may assist in identifying underlying risks that would threaten the survival of the entity, and that should therefore be considered by the board as part of its assessment of the Company's ability to continue as a going concern (2.12).

The need to take actions outside the normal course of business is also discussed in the Guidance in the context of determining whether there are material uncertainties (2.30 and 2.31).

The Guidance indicates that what is within or outside the normal course of business is a matter of judgement. It explains (2.12, 2.13 and A1.23) their nature and potential implications for shareholders, creditors and other stakeholders and provides guidance on interpreting whether actions are within or outside the normal course of business (2.14 and A.1.24 to A.125).

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?***

The foreseeable future

Although there is a minimum period over which boards should assess going concern, there is no maximum period. The board is expected to develop a high level of confidence that solvency and liquidity risks can be managed effectively during at least the period of twelve months from the date of the assessment (2.22).

The Guidance states that the evaluation of significant solvency and liquidity risks should consider the foreseeable future (ie. what the board knows or should be reasonably expected to know about the future). The length of the periods considered in carrying out individual aspects of the assessment process (such as developing medium term strategic plans and budgets and stress tests) is a matter of judgement and should in principle be consistent with the periods appropriate for effective business planning and management. They should reflect the company's business, its business cycles and the stage of the general economic cycle at the time of the assessment (2.19 to 2.22 and A1.1 to A1.13).

***<u>Question 4:</u>* 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?**

Different uses of the term 'going concern'

The term 'going concern' is used in the Code and in the accounting and auditing standards in a number of ways and contexts and there is therefore a risk that these may be confused. The Guidance seeks to avoid such confusion by distinguishing the different uses of the term. The Code requires the board to state that the company **<u>is</u> a going concern**. The accounting and auditing standards do not require the direct determination as to whether the company is or will continue to be a going concern. Rather they require the board to decide whether:

(a) The **going concern basis of accounting** is appropriate (providing specific disapplication criteria); and
(b) There are 'material uncertainties' about the Company's **ability to continue as a going concern**.

The Panel indicated in its preliminary report (PR Rec 2) that the FRC should consider whether the statement required under the Code was too definitive. In its final report, however, the Panel concluded that, if there were a clearer definition of a going concern, it should not be necessary to modify the requirement of the Code (FR88). The Guidance includes a description of when an entity should be judged to be a going concern (see above).

The Panel concluded that the criteria for disapplication of the going concern basis of accounting do not require or imply a high degree of certainty that a company that adopts the going concern basis of accounting will in fact avoid liquidation or that it will not cease trading. The Panel also clearly distinguishes between those criteria, the application of which is substantively a matter of fact, and the criteria for when an entity should be judged to be a going concern (FR 97), the application of which is not.

In light of this, the Guidance clearly distinguishes between the criteria for the judgement as to whether an entity is a going concern for the foreseeable future and those for determining whether the going concern basis of accounting should be applied. The Guidance (2.27), explains that the criteria for disapplication of the going concern basis of accounting may not be reached even when the company is not judged to be a going concern.

The Guidance considers the company's ability to continue as a going concern (as referred to in the context of material uncertainties in the accounting and auditing standards) as having much the same meaning as the Code statement that the entity <u>is</u> a going concern. However, the focus of the material uncertainty criterion (see below) is to determine whether there are uncertainties in making the judgement as to whether the entity is a going concern that should be disclosed.

As discussed in paragraphs 28 to 31 of the Guidance, disclosure of a material uncertainty may be appropriate due to a combination of the probability and impact of the underlying issue and of any identified mitigating actions. When the board is unable to obtain a high level of confidence about the entity's solvency and liquidity for the foreseeable future, but the going concern basis of accounting is appropriate, there will be material uncertainties to disclose. However, there may also be material uncertainties to disclose even if the board is able to obtain a high level of confidence. For example, there could still be a meaningful possibility of an underlying issue with a severe impact crystallising, but of available mitigating actions not being effective.

***<u>Question 5:</u>* 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 '<u>is</u> 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?**

Determining when there are material uncertainties to be disclosed

The Panel's views as to the purpose of material uncertainty disclosures (FR 97, 100 and 104) are reflected in the Guidance (2.28 and 2.29). The Guidance also addresses when uncertainties should be considered material (2.29), adopting the Panel's view that this is a matter of judgement (2.30) having regard to the usefulness of disclosure about those uncertainties to the economic decisions of shareholders and other stakeholders (FR 100). The Guidance sets out factors that the board should consider in making this judgement (2.30) and certain circumstances in which they should or should not usually be considered material (2.31). These are neither intended to be comprehensive, nor to limit such a judgement.

***<u>Question 6:</u>* 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?**

Determining when narrative disclosures should be made

The Panel's views as to how narrative disclosure of significant solvency and liquidity risks should be made (FR 136 and 137), are reflected in the Guidance (4.8 and 4.9).

Changes to FRS 18 and ISA (UK and Ireland) 570

Recommendation 2(b) also refers to clarifying the purposes, thresholds and descriptions of the matters it addresses in FRS 18 and ISA (UK and Ireland) 570. The Panel also recommended that the FRC seek to develop a common international understanding of the use of the term going concern. The FRC considers that the interpretation of these matters in the Guidance is consistent with FRS 18 and ISA (UK and Ireland) 570. The FRC is seeking to influence the outcome of international developments in relation to these matters at the IASB and IAASB. The FRC will consider whether further changes are needed to the UK and Ireland accounting and auditing standards or to the Guidance in light of further developments.

***<u>Question 7:</u>* 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?**

Panel Recommendation 3

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.

Section 2 of the Guidance implements these recommendations as follows:

(a) Integrating the going concern assessment with the directors' business planning and risk management processes (2.1(a) and 2.3)).

(b) Focus on both solvency and liquidity risks, with a more qualitative and longer term focus on solvency risks (2.1 (a) and 2.3 (a)).

(c) Identifying risks that would threaten the company's survival over the economic cycle and the company's own business cycles (2.3 (b)). Guidance on the identification of such risks is further explained by reference to the onset of severe economic or financial distress and the need to take actions outside the normal course of business (2.12 to 2.13 and A.1.14 to A.1.23).

(d) Prudent stress tests should be undertaken in relation to both solvency and liquidity risks and with appropriate consideration given to risks that could cause damage to stakeholders having regard to the directors' duties and responsibilities (2.2(c), 2.17 and A1.26 to A1.27). This includes an explanation of the concept of prudence.

***<u>Question 8:</u>* 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?**

Panel Recommendation 4

The Panel recommends that, in taking forward its work on reporting under ECS, the FRC should move away from a model where disclosures about going concern risks are only highlighted when there are significant doubts about the entity's survival, to one which integrates going concern reporting with the ECS proposals through seeking 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;

and recommends that the FRC should amend the standards and guidance for directors and auditors accordingly when the ECS proposals have been finalised.

The revisions in the September 2012 edition of the Code and the October 2012 edition of the auditing standards included changes designed to implement the proposals originally set out in the FRC discussion paper "Effective Company Stewardship – Enhancing Corporate Reporting and Audit" issued in January 2011 (referred to as 'ECS in the Panel's recommendation). These revisions (as modified in light of feedback to the original proposals) apply to companies that are required, or choose voluntarily, to report on how they have applied the Code and are intended to:

(a) Enhance board reporting by requiring boards to set out in the annual report:
   a. A statement that the board considers the annual report is fair, balanced and understandable and provides the information necessary for shareholders to assess the company's performance, business model and strategy (it is for the board to determine whether it wishes to receive the advice of the audit committee in relation to this); and
   b. The work of the audit committee in discharging its responsibilities, including the significant issues that it considered in relation to the financial statements (including consideration of matters communicated to it by the auditor) and how these issues were addressed.

(b) Enhance auditor communications by requiring the auditor to communicate to the audit committee:
   a. Information relevant to the board (and if applicable the audit committee) in fulfilling their responsibilities for making the statement that the annual report is fair, balanced and understandable and for reviewing the effectiveness of the company's risk management and internal control systems;
   b. The information that the audit committee needs to understand the auditor's significant professional judgements in the course of the audit and in reaching their audit opinion and the auditor's insights about the entity's internal control system based on their audit work.

(c) Require the auditor to report explicitly whether they have any reason to believe that:
   a. The board's statement that the annual report is fair, balanced and understandable is inconsistent with the knowledge the auditor acquired in the course of the audit; or
   b. The matters disclosed in the section of the annual report describing the work of the audit committee do not appropriately address matters communicated by the auditor to the audit committee.

To support the above enhancements to auditor reporting, a change was also made (that is applicable to all audits) requiring the auditor to read the annual report in the light of the knowledge the auditor has acquired in the course of the audit.

Integrating the board's reporting responsibilities and how it obtains assurance about them

Consistent with the approach adopted in the September 2012 edition of the Code, the Guidance makes it clear that responsibility for identifying, evaluating and reporting about significant solvency and liquidity risks remains with the board (3.14) and that it is for the board to determine the extent to which it wishes to obtain the advice of the risk committee or the audit committee (3.10). The audit committee has a direct role in relation to those aspects of the going concern assessment and reporting process that are relevant to its responsibilities for financial reporting and internal financial control under the Code (3.5).

The Guidance implements the board's reporting requirements in Recommendation 4 as follows:

(a) The discussion of strategy and principal risks incorporates the directors' statement that the Company is a going concern and how they arrived at it (4.1 (a) and 4.8 (b))
(b) The board confirms in the annual report the robustness of the going concern process and its outcome and illustrates this by reference to the issues it addressed rather than by describing process. (4.1 (c), 4.2 and 4.8 (a))
(c) The board's reporting under (a) and (b) should be considered by the directors in making the statement that the annual report and accounts is fair, balanced and understandable (3.17); and
(d) The audit committee communicates its advice on going concern matters that fall within its responsibilities to the board and these are addressed as appropriate in the section of the annual report dealing with its work (3.16).

<u>Question 9:</u>* 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?

Integrating the auditor's communications and reporting responsibilities

Proposed revisions to ISA (UK and Ireland) 260 (Revised October 2012) "Communication with those charged with governance"

Proposed paragraph 16-1(e) requires the auditor to communicate to the audit committee the auditor's views on the robustness of the directors' going concern assessment and its outcome, including the related disclosures in the annual report and accounts.

Application and other explanatory material is provided by proposed paragraphs A20-6 and A20-7. These paragraphs explain the requirement of Provision C.1.3 of the UK Corporate Governance Code and the equivalent requirement in the Listing Rules. They also refer to the Guidance as providing guidance to assist directors in making their assessment of going concern and its outcome, including the related disclosures in the annual report and accounts.

Proposed revisions to ISA (UK and Ireland) 570 "Going concern"

Proposed paragraph 17-2 requires the auditor to read and consider the following elements of the annual report in light of the knowledge the auditor acquired during the audit, including that acquired in the evaluation of management's assessment of the entity's ability to continue as a going concern:

(a) The directors' going concern statement; and

(b) The disclosures, in the section of the annual report that addresses the work of the audit committee, about the directors' assessment of going concern.

Proposed paragraph 17-3 requires that the auditor should consider whether:

(a) The auditor is aware of information that would indicate that the annual report and accounts taken as a whole is not fair, balanced and understandable in relation to the going concern status of the entity; and
(b) Matters relating to the going concern status of the entity that the auditor communicated to the audit committee are not appropriately addressed in the section of the annual report that describes the work of the audit committee.

Panel Recommendation 5

"The Panel recommends that, as part of its work on auditor reporting arising from the ECS proposals, the FRC should:

(a) consider moving UK auditing standards towards inclusion of an explicit statement in the auditor's report as to whether the auditor has anything to add to or emphasise in relation to the disclosures made by the directors about the robustness of the process and its outcome, having considered the directors' going concern assessment process; …"

Section 4 of this consultation document contains extracts from the affected auditing standards reflecting the changes stemming from the implementation of the Panel's recommendations.

Proposed revisions to ISA (UK and Ireland) 570 "Going concern"
Proposed paragraph 17-2 also requires the auditor to determine whether there is anything it should add or draw attention to in the auditor's report on the financial statements in relation to the elements of the annual report referred to in that paragraph (see above) and to report them in accordance with the requirements of ISA (UK and Ireland) 700.

Proposed revisions to ISA (UK and Ireland) 700 (Revised October 2012) "The auditor's report on financial statements"
Proposed paragraph 22C imposes the reporting requirement in Recommendation 5, reflecting the requirement to conclude on this in proposed paragraph 17-2 of ISA (UK and Ireland) 570.

***<u>Question 10:</u>* 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?**

Supplementary guidance for banks

The Panel set out in its final report (FR 161 to 203) its views about the special considerations for banks and why it concluded that it was not necessary to develop a separate disclosure regime for banks and their auditors in relation to the going concern assessment. The background (updated), the rationale for this conclusion and supplementary guidance for banks has been set out in the Supplement to the Guidance. The Supplement confirms that liquidity support from central banks may be a normal funding source for banks and reliance on such support does not necessarily mean that the bank is not a going concern or that material uncertainties should be disclosed or an emphasis of matter paragraph included in the auditor's report.

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?***

Other considerations

Implementation date for the Guidance

The Guidance states that it should be applied for financial years commencing on or after 1 October 2012 with early adoption encouraged.

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

Analysis of benefits, costs and other impacts

Consistent with the proposals of the Panel, the FRC considers that the benefits of implementing the Panel's recommendations will be to create a framework which encourages better management of and reporting to stakeholders about the significant risks that threaten the survival of companies, enabling better stakeholder engagement about these matters whilst not inhibiting appropriate risk taking that is essential to foster and reward investment. The proposed Guidance and changes to the auditing standards have also been drawn up with a view to avoiding unnecessary costs or consequences for the way boards or auditors meet their responsibilities.

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?***

Guidance for SMEs

The Guidance applies to all companies and their boards insofar as it addresses their Companies Act narrative and financial reporting responsibilities. For companies that are required, and those that choose voluntarily, to report on how they have applied the Code, it also applies in addressing the further requirements applicable to such companies and the further responsibilities of their boards under the Code. The document includes a short section setting out considerations for SMEs (2.33 to 2.36).

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?***

Other matters for consideration in the Guidance or Supplement

<u>Question 15:</u> ***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?***

Section 3 – Guidance on Going Concern 2013

January 2013

Consultation Draft: Guidance on Going Concern

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Contents

Preface

This Guidance reflects the recommendations of the Sharman Panel of Inquiry into *Going concern and liquidity risks: lessons for companies and auditors*[1] and replaces *"Going concern and liquidity risk: Guidance for directors of UK companies 2009"*. The Panel was commissioned in the aftermath of the financial crisis to identify lessons for companies and auditors addressing going concern and liquidity risks and recommend any necessary improvements to the existing reporting regime and guidance for companies and auditors in relation to these matters.

The previous guidance focused primarily on assessing the going concern basis of accounting and identifying any material uncertainties about the ability of the company to continue as a going concern, when preparing annual and half-yearly financial statements. It encouraged periodic assessment of short term liquidity – the ability to generate cash and maintain adequate financing facilities to meet liabilities as they fall due. In terms of disclosure, it encouraged a focus on the going concern basis of accounting, material uncertainties, liquidity risk and other disclosures required to give a true and fair view and, in the discussion of principal risks in the business review, any particular economic conditions and financial difficulties the company was experiencing.

The Panel's recommendations and this Guidance build on these but seek to go further and engender a more broadly-based and more continuous assessment of going concern – one that is integrated with the processes for setting strategy, managing risks and running the business and that includes an assessment of the sustainability of the business model in the longer term and the company's adaptability in the face of economic and financial stress. The overarching aim is to enhance the board's consideration of the risks that would threaten the survival of the company (and how they are managed) and, in terms of narrative reporting, to provide a better articulation of these matters, even when those risks are not heightened. The Guidance also seeks to promote a more common understanding as to when a company should be judged to be a going concern (that is not linked to the very high threshold for departing from the going concern basis of accounting) and as to what constitutes a material uncertainty.

This Guidance implements the Panel's recommendations in the context of the updated UK Corporate Governance Code issued in September 2012. This indicates that the directors should state that they consider the annual report and accounts taken as a whole is fair, balanced and understandable and provides the information necessary for shareholders to assess the company's performance, business model and strategy[2]. The updated Code and related changes to the Guidance on Audit Committees also introduce enhanced reporting by the audit committee. These provisions are likely to be pertinent to the board's going concern assessment and related disclosures.

This Guidance has been issued concurrently with [proposed] amendments to the auditing standards to implement the Panel's recommendations for an enhanced role for the auditor in relation to going concern.

The Panel also addressed the going concern risks affecting banks. Considerations for the banking sector are included in the attached Supplement to this Guidance.

This Guidance is applicable for financial years commencing on or after 1 October 2012 but early adoption is encouraged.

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[1] See http://www.frc.org.uk/Our-Work/Headline-projects/The-Sharman-Inquiry.aspx
[2] See Code Provision C.1.1

Section 1 – Introduction and Overview

Who is this guidance for?

1. This Guidance applies to all companies and their boards insofar as it addresses their Companies Act narrative and financial reporting responsibilities. For companies that are required, and those that choose voluntarily, to report on how they have applied the Code, it also applies in addressing the further requirements applicable to such companies and the further responsibilities of their boards under the Code.

2. This Guidance will also be useful in assisting others, such as shareholders and auditors, to understand the board's going concern responsibilities following implementation of the recommendations of the Panel.

Why is going concern assessed and reported on?

3. The overarching purpose of the going concern assessment is 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.

4. There are two purposes of going concern reporting:
   (a) Stewardship purpose – to provide information to stakeholders about the company's economic and financial viability, helping to demonstrate the board's stewardship and governance and encouraging shareholders to perform their own stewardship role by engaging in appropriate dialogue with the board and holding the directors to account as necessary.
   (b) Financial reporting purpose – to establish and disclose the information about going concern needed for the financial statements to give a true and fair view.

5. In relation to the stewardship purpose, the board is required to make a statement that the business is a going concern, together with supporting assumptions or qualifications as necessary[3]. Under this Guidance, the board should also confirm in the annual report that it undertook a robust going concern assessment and should illustrate the effectiveness of that process with reference to the significant solvency[4] and liquidity[5] risks which it considered and, if appropriate, how they were addressed.

6. In relation to the financial reporting purpose, the board is required to disclose in the financial statements if it concludes that the going concern basis of accounting[6] is not appropriate and if it

[3] See Listing Rule 9.8.6R(3) and Code Provision C.1.3

[4] Solvency is the entity's ability to meet its liabilities in full. This involves managing the sufficiency of its capital so that it has an appropriate excess of assets over liabilities (at least in the long run). Additionally, in order to have a realistic prospect of continuing to be solvent, the entity must develop and maintain an economic (business) model which is capable of delivering over time a continuing economic return (at or above the cost of capital) for its providers of capital. Solvency is therefore about the viability of the business model and the maintenance of its capital.

[5] Liquidity is concerned with the entity's ability to liquidate its assets (and/or to generate cash profits or to access new sources of short term funds) at the velocity needed to meet its liabilities as they fall due. Liquidity is therefore more relevant to the short term survival of the entity.

[6] The exact requirements for when the going concern basis of accounting should be adopted differs between accounting frameworks but under IFRS and UK GAAP it is based on whether management either intends to liquidate the company or to cease trading or has no realistic alternative but to do so. Paragraph 25 of IAS 1 states that: "An entity shall prepare financial statements on a going concern basis unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so." The equivalent requirement under UK GAAP is in paragraph 21 of FRS 18 [to update for FRS 102] (see also FRSSE paragraph 2.12).

concludes that there are material uncertainties[7] about the entity's ability to continue as a going concern.

7. Further information on relevant regulatory and reporting requirements is included in Appendix 2.

8. The stewardship purpose is closely linked to the board's responsibility for promoting the company's success[8]. In fulfilling this responsibility, it pays particular attention to the management of those risks or combinations of risks that can so seriously damage the sustainability of the company's cash flows, performance or future prospects that they would threaten the solvency or liquidity of the company, or its licence to operate, and therefore its survival. The risks may stem from failures of the business model, strategy, operations, organisation, management or behaviour, or from external factors over which the board may have little or no direct control.

9. Good stewardship by the board should not inhibit sensible risk taking that is critical to the growth and maintenance of economic activity. The possibility that financial or economic distress will occur and the possibility of failure cannot be eliminated. However, the going concern assessment and reporting should support better risk decision-taking within the business; ensure that shareholders, creditors and other stakeholders are well-informed about those risks; and sustain a corporate environment in which the directors and management recognise, acknowledge and respond to potential or actual economic and financial distress sooner rather than later.

10. The board's assessment of going concern should not therefore be an exercise undertaken in isolation when preparing annual or half-yearly financial statements. Instead, it should be embedded in the company's on-going business planning processes, risk management framework and internal controls and their governance so that the significant solvency and liquidity risks are effectively managed.

11. The information required for the periodic narrative reporting and the accounting conclusions and disclosures should then fall naturally from the review of the significant risks identified and managed in the underlying processes.

What is a going concern?

12. In this Guidance, 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.

How are the going concern assessment and reporting responsibilities met?

The Going Concern Assessment Process (Section 2)

[7] In the case of the IFRS framework, whether there are material uncertainties related to events or conditions that may cast significant doubt upon the company's ability to continue as a going concern – paragraph 25 of IAS 1 states that: "When management is aware, in making its assessment, of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, the entity shall disclose those uncertainties." The equivalent requirement under UK GAAP is in paragraph 26 of FRS 18 [to update for FRS 102] (see also FRSSE paragraph 2.12).

[8] Section 172, Companies Act 2006: "*A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole*, and in doing so have regard (amongst other matters) to: (a) the likely consequences of any decision in the long term; (b) the interests of the company's employees; (c) the need to foster the company's business relationships with suppliers, customers and others; (d) the impact of the company's operations on the community and the environment; (e) the desirability of the company maintaining a reputation for high standards of business conduct; and (f) the need to act fairly as between members of the company."

13. The going concern assessment process should have two related elements:
    (a) A review of the company's solvency and liquidity position and significant risks informed by the company's business planning processes, risk management framework and internal controls, designed to allow the board to reach a conclusion as to whether the company is a going concern[3]; and
    (b) Based on that review, a decision by the board as to whether the financial statements should be drawn up on a going concern basis[6] and whether there are material uncertainties about the company's ability to continue as a going concern[7].

14. The first element should include, but need not be limited to:
    (a) An evaluation of both solvency and liquidity risks, with a longer-term, more qualitative approach being taken to solvency;
    (b) The identification of solvency risks that would threaten the survival of the company over the general economic cycle and its specific business cycles; and
    (c) Prudent stress tests in relation to both solvency and liquidity.

Going Concern Assurance (Section 3)

15. The board should obtain assurance about the:
    (a) robustness of the going concern assessment process and its outcome;
    (b) conclusion as to whether the company is a going concern;
    (c) adequacy of its narrative going concern reporting to meet the stewardship purpose; and
    (d) going concern basis of accounting and material uncertainty decisions and related financial statement disclosures.

16. This should be integrated with the board's wider governance responsibilities[9] for:
    (a) Presenting the financial statements of the company and determining its solvency and the reserves from which any distributions will be made;
    (b) Determining the nature and extent of the significant risks the board is willing to take in achieving its strategic objectives and maintaining sound risk management and internal control systems;
    (c) Reviewing the effectiveness of the company's risk management and internal control systems; and
    (d) Ensuring that the annual report and accounts, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the company's performance, business model and strategy.

17. Sources of assurance for the board may include:
    (a) The board's own consideration of the appropriateness and prudence of the accounting policies it has adopted;
    (b) The board's own monitoring and challenge of management's processes relating to the going concern assessment and the risk management and internal control systems and the outputs from these;
    (c) The audit committee monitoring and advising on going concern aspects of the integrity of financial reporting and the effectiveness of internal financial control;
    (d) If requested by the board, the audit committee or the risk committee advising on any of these processes or the board's overall going concern assessment;

[9] Responsibilities under the Companies Act 2006 (Parts 15 and 23) and the Code (Section C: Accountability)

(e) The external auditor’s communications to the audit committee about matters it considers relevant to the board and the audit committee in fulfilling their going concern responsibilities; and

(f) Obtaining reports on relevant matters from any compliance, risk management and internal audit functions.

Reporting on Going Concern (Section 4)

18. The key elements of reporting on going concern are:

(a) The board’s conclusion as to whether the company is a going concern, given in the business review in the context of the description of the company’s performance, business model, strategy and principal risks; what the board has regarded as the foreseeable future;

(b) An explanation of the rationale for that conclusion, articulating the risks that would threaten the survival of the company and how they were managed;

(c) The board’s confirmation that a robust going concern assessment process was undertaken and illustration of how it obtained assurance about that;

(d) Confirmation in the financial statements that the going concern basis is adopted or, if not, an explanation and a description of the alternative basis adopted;

(e) Appropriate disclosures in the financial statements about any going concern material uncertainties identified; and

(f) Explicit conclusions in the auditor’s report about the going concern assessment and reporting and an emphasis of matter paragraph when there are material uncertainties[10]**.**

19. The narrative reporting should as far as practical stand alone in telling a clear story about the solvency and liquidity risks, about the company’s ability to continue as a going concern and about the board’s stewardship of the company in this respect whilst providing, and explaining, appropriate (but not excessive) links to relevant supplementary information elsewhere in the annual report and financial statements.

[10] See ISA (UK&I) 570, Going concern (Paragraph 17): “*A material uncertainty exists when the magnitude of its potential impact and likelihood of occurrence is such that, in the auditor’s judgement, appropriate disclosure of the nature and implications of the uncertainty is necessary for: (a) in the case of a fair presentation financial reporting framework, the fair presentation of the financial statements, or (b) in the case of a compliance framework, the financial statements not to be misleading*”; [proposed] paragraph 22C of ISA (UK and Ireland) 700 (Revised October 2012) “The auditor’s report on financial statements”; [proposed] paragraph 16-1 (e) of ISA (UK and Ireland) 260 (Revised October 2012) “Communication with those charged with governance”; and [proposed] paragraphs 17-2 and 17-3 of ISA (UK and Ireland) 570 “Going concern”.

Section 2 – Going Concern Assessment Process

1. The going concern assessment process should have two related elements:
   (a) A review of the company's solvency and liquidity position and significant risks informed by the company's business planning processes, risk management framework and internal controls, designed to allow the board to reach a conclusion as to whether the company is a going concern[3]; and
   (b) Based on that review, a decision by the board as to whether the financial statements should be drawn up on a going concern basis[6] and whether there are material uncertainties about the company's ability to continue as a going concern.

2. The first element should include, but need not be limited to:
   (a) An evaluation of both solvency and liquidity risks, with a longer-term, more qualitative approach being taken to solvency;
   (b) The identification of solvency risks that would threaten the survival of the company over the general economic cycle and its specific business cycles; and
   (c) Prudent stress tests in relation to both solvency and liquidity.

A sound system to support the going concern assessment process

3. The board is responsible for determining the nature and extent of the significant risks it is willing to take in pursuing its strategic objectives, for maintaining sound risk management and internal control systems[11] and for reviewing the effectiveness of those systems[12]. A key element of the going concern assessment process is to ensure that these systems appropriately address the objectives of the going concern assessment, including matters relating to the sustainability of the business model and the company's solvency and liquidity.

4. The appropriate design of the assessment process depends on the circumstances of the company and is a matter for the judgement of the board, with the support of management. Circumstances may vary over time with changes in the business model, performance, strategy and operational processes and with the stage of development the company has reached in its own business cycles (for example, a company may face heightened cash flow risks when developing and launching a major new product).

5. There may also be changes in the external environment, including the evolution of external risks in the general economic cycle (for example, refinancing and credit risks are likely to be higher in recessionary times),.

6. The appropriate design also depends on other factors – for example:
   (a) The higher the tolerated solvency and liquidity risks, the need for stronger and more timely monitoring controls and contingency planning may be greater; and
   (b) The greater the exposure to low probability high impact solvency and liquidity risks, the need for effective crisis management systems may be greater.

[11] See Code Principle C.2 – Relevant guidance is set out in Section Two of *Internal Control: Revised Guidance for Directors on the Combined Code – October 2005*.
[12] See Code Provision C.2.1 – Relevant guidance is set out in Section Three of *Internal Control: Revised Guidance for Directors on the Combined Code – October 2005*.

7. The system should have the ability to identify and respond quickly to evolving and new solvency and liquidity risks. Failure to identify or to acknowledge and address the onset of financial or economic distress is often cited as a factor that leads companies to fail, when recovery may have been feasible had acknowledgement of the issues come sooner.

8. Systems for monitoring, evaluation and reporting of these risks should have regard to the nature of the risks, the experience of management and the behavioural incentives of the individuals involved. For example, one frequently cited cause of distress and failure is poor management – the remedy may be management change or the need for specialist recovery skills. Monitoring, evaluation and reporting controls may not be effective in the face of such risks without board action including direct non-executive engagement, at least when those risks are heightened. This could include effecting management change or changing incentive structures.

9. In order to allow the board to reach a conclusion as to whether the company is a going concern, the assessment process should be undertaken exercising the standard of care generally applicable to directors in the exercise of their duties and should:

Identify, evaluate and address the significant solvency and liquidity risks

10. The board should identify the significant solvency and liquidity risks and evaluate: the likelihood of their incidence; their impact if they were to crystallise; the availability and likelihood of effectiveness of actions (whether within or outside the normal course of business) that they would consider undertaking to avoid or reduce the impact or occurrence of the underlying risks and that realistically would be open to them in the circumstances; and whether they have been appropriately addressed.

11. The significant solvency and liquidity risks are those risks or combinations of risks that (in the judgement of the board) could so seriously damage the company's cash flows, performance or future prospects that they would give rise to severe economic or financial distress if they crystallised (see Appendix 1 – paragraphs 14 to 22 for a discussion of solvency and liquidity risks and their relationship with economic and financial distress).

12. What constitutes severe distress is a matter of judgement – when the company would have no realistic alternative but to take significant actions outside the normal course of business to address the distress, this is usually symptomatic of it being severe (see also Appendix 1 – paragraph 23). Such actions would include, for example:
    (a) discontinuing or materially curtailing the company's operations; or
    (b) raising finance (or making changes to existing finance) outside the normal course of business or on other than normal terms or doing so from other than normal sources.

13. The board's consideration of whether there is severe distress should take full account of the availability and likelihood of effectiveness of actions within the normal course of business that they would consider undertaking to avoid or reduce the impact or occurrence of the underlying risks and that realistically would be open to them in the circumstances.

14. Whether actions are within or outside the normal course of business is also a matter of judgement, and should be determined by the board having regard to the implications for the board's strategic objectives, its financial adaptability and contingency plans and the likely implications for shareholders, creditors and other stakeholders (see also Appendix 1 – paragraphs 24 and 25). The following examples may help to differentiate between taking actions within or outside the normal course of business:

	Within	*Outside*
Raising capital	*Planned issue to shareholders with pre-emption rights to fund the expansion of a profitable subsidiary*	*A heavily discounted and underwritten rescue rights issue to generate funds to repay or reduce defaulting debt*
Disposals	*Sale of an overseas division, as part of a board's long-term strategic plan, returning a substantial element of the proceeds to shareholders*	*Emergency disposal of a profitable subsidiary or asset to fund the costs of a crisis*
Bank debt	*Renegotiation of existing facilities and changes to covenants in connection with the acquisition of a new subsidiary*	*Negotiating a standstill agreement, or renegotiating covenants to avoid breaching them, in response to a severe trading downturn*

15. The evaluation of risks may be quantitative and/or qualitative; for some risks, there may be little quantitative past experience data and, even when available, this may have little predictive power for future events or outcomes.

16. In evaluating impact, the board should consider the sufficiency of the company's risk management processes and internal controls and specifically the financial adaptability and contingency plans to address these risks. In relation to the significant solvency and liquidity risks, the board should establish clearly the extent to which the risks are to be avoided or transferred, mitigated or tolerated.

17. The board should undertake stress tests and reverse stress tests on a prudent basis. The use of stress tests (including reverse stress tests) to review different strategic scenarios may assist boards in identifying and evaluating the significant solvency and liquidity risks. (see Appendix 1 – paragraphs 26 to 37)

18. The aim should be to provide confidence that the risk management and internal control systems are operating effectively in relation to significant solvency and liquidity risks, including that the options determined for addressing them have been properly executed and remain effective.

Consider the 'foreseeable future'

19. The board's evaluation of the significant solvency and liquidity risks should consider the foreseeable future, ie what the board knows or should reasonably be expected to know about the future. The foreseeable future is not a specific period. Knowledge about the future is a matter of judgement not fact and reflects the expertise and experience of those making the evaluations about the likely development of events and conditions in future periods as part of the assessment process.

20. 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 board is expected to develop a

high level of confidence that solvency and liquidity risks can be managed effectively during at leastthat period.

21. When considering solvency, boards address longer periods through the general economic and specific business cycles. The length of the period considered is a matter of judgment 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.

22. Determining the appropriate periods to be covered in carrying out individual aspects of the assessment process (such as the qualitative and quantitative evaluation of risks and potential mitigants, the development of budgets, forecasts and medium term strategy and plans, and the conduct of stress tests) is therefore a key aspect of establishing a sound assessment process. The appropriate periods for this purpose should in principle be consistent with those appropriate for effective business planning and management (see also Appendix 1 – paragraphs 1 to 13).

Monitor the significant solvency and liquidity risks

23. The board should monitor the evolution of existing and the emergence of new risks and the implications for the board's on-going assessments and decisions about significant solvency and liquidity risks.

24. Effective reporting systems should provide for immediate reporting to the board of new information that may challenge the latest assessments and decisions the board has made about significant solvency and liquidity risks.

Assess the sufficiency and reliability of the sources of assurance

25. A sound system to support the going concern assessment process will assess the sufficiency and reliability of the sources of assurance (Section 3).

Deciding whether to adopt the going concern basis of accounting

26. There is a common understanding that the purpose of the decision whether to adopt the going concern basis of accounting or a liquidation basis of accounting is to ensure that financial reporting consistently follows the going concern basis except in those very rare circumstances where there is no realistic alternative to liquidation or cessation of operations.

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. For example, the board may have realistic alternatives to liquidation or cessation and a high level of confidence that these will be effective in avoiding that outcome. Nonetheless, there may be material uncertainties about their effectiveness or about the severity of the impact of the risks.

Deciding whether there are material uncertainties

28. There is not yet a common international understanding of the purpose of the assessment as to whether there are material uncertainties about the company's ability to continue as a going concern. At present, some interpret no mention of material uncertainties in an annual report as effectively guaranteeing a company's survival for the next 12 months whilst others see any mention of a material uncertainty as a portent of imminent collapse. Neither is appropriate.

29. In this Guidance, the interpretation adopted[13] is that the purpose is to forewarn of significant solvency or liquidity risks of such a potential magnitude and such a meaningful possibility of occurrence that, if disclosed, they would provoke serious questions about their implications for the entity's ability to continue as a going concern and this would affect the economic decisions of shareholders and other users of the financial statements. This is a matter of judgment. In this respect, the board should consider each of the significant solvency and liquidity risks identified, both individually and in combination with others.

30. Possible implications of such risks, and the uncertainties inherent in them, that could influence the decisions that users make on the basis of the financial statements include, for example, effects on the realisable values of the company's assets or liabilities, its credit rating or the board's ability to pursue its strategy and business model. In determining whether there are material uncertainties, the board should consider:
    (a) the magnitude of their potential impact on the company and the likelihood of their occurrence;
    (b) the availability and likelihood of effectiveness of actions (whether within or outside the normal course of business) that the board would consider undertaking to avoid or reduce their impact or occurrence and that realistically would be open to it in the circumstances; and
    (c) the potential implications for shareholders and other users of the financial statements of the crystallisation of the risks and of any actions that would be taken to address them.

31. It is a matter of judgement as to whether they are material. However:
    (a) they should usually be considered material if:
        a. they have at the time of the board's assessment given rise to severe economic or financial distress for which there is no realistic alternative but to take actions outside the normal course of business in order to address it, and the directors are not able to obtain a high level of confidence that such actions will be available to them and will be highly likely to be effective; or
        b. it is more likely than not that they will, within the foreseeable future, give rise to such distress with that consequence in such circumstances; but
    (b) they should not usually be considered material if the likelihood that the company will not be able to continue as a going concern is assessed to be remote, however significant the assessed potential impact.

Relationship of disclosures to meet the financial reporting and stewardship purposes

32. As discussed above, disclosure of a material uncertainty may be appropriate due to a combination of the probability and impact of the underlying issue and of any identified mitigating actions. When the board is unable to obtain a high level of confidence about the entity's solvency and liquidity for the foreseeable future, but the going concern basis of accounting is appropriate, there will be material uncertainties to disclose. However, there may also be material uncertainties to disclose even if the board is able to obtain a high level of confidence. For example, despite obtaining a high level of confidence, there could still be a meaningful possibility of an underlying issue that would have a severe impact crystallising but of available mitigating actions not being effective in addressing it.

33. The board should judge the company to be a going concern in the circumstances described in paragraph 6(a) of Section 4 and should not judge the company to be a going concern in the circumstances described in paragraph 6(c) of Section 4. However, in the circumstances described in

[13] This interpretation may need to be further refined in due course in light of international developments.

paragraph 6(b) of Section 4, the board may or may not be able to judge the company to be a going concern, depending on the level of confidence that it is able to obtain.

Half-yearly financial statements

34. Where boards are required to prepare half-yearly financial statements, the same considerations should apply as for the annual financial statements. Boards should continue to undertake their integrated assessment of going concern considerations as part of their on-going governance of risk management and internal controls. Boards should therefore build on their understanding of going concern issues since the completion of the last annual report, update their conclusions and revise their disclosures as necessary.

Considerations for SMEs

35. The importance of the assessment of the ability to continue as a going concern is essentially the same for all companies. Whilst some smaller entities may have less complex trading, organisational or financing arrangements, others may not, and directors carefully consider the extent and nature of the assessment that is appropriate given the particular circumstances of the company.

36. Less complex companies may have less complex business planning, risk management and internal control systems. Identification and evaluation of significant solvency and liquidity risks, consideration of how they should be addressed and on-going monitoring of such risks is nonetheless important[14].

37. The extent to which boards of smaller companies should carry out stress tests is a matter of judgement and will depend, for example, on the nature and complexity of the company's business and capital structure. However, sensitivity analysis on key aspects of their financial performance (for example, sales projections or cash collections) is likely to be needed even for smaller companies.

38. Medium-sized companies are required to produce a business review discussing the business model, strategy and principal risks, under SI 2005/1011[15], but small companies are not required to do so. Under the Government's proposals for narrative reporting[16], a strategic report, discussing similar matters, would replace the business review but small companies would be exempt from preparing a narrative report.

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[14] Boards of companies which apply the FRSSE will consider a range of budgets, cash flow forecasts and profit projections and other factors appropriate to their business. See: *An Update for Directors of Companies that adopt the Financial Reporting Standard for Smaller Entities (FRSSE): Going Concern and Financial Reporting (FRC, March 2009)*

[15] Companies Act 1985 (Operating and Financial Review and Directors' Report etc) Regulations 2005

[16] The Future of Narrative Reporting, BIS (October 2012) and The Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013 (Draft).

Section 3 – Going Concern Assurance

1. The board should obtain assurance about the:
   (a) robustness of the going concern assessment process and its outcome;
   (b) conclusion as to whether the company is a going concern;
   (c) adequacy of its narrative going concern reporting to meet the stewardship purpose; and
   (d) going concern basis of accounting and material uncertainty decisions and related financial statement disclosures.

2. This should be integrated with the board's wider governance responsibilities[9] for:
   (a) Presenting the financial statements of the company and determining its solvency and the reserves from which any distributions will be made;
   (b) Determining the nature and extent of the significant risks the board is willing to take in achieving its strategic objectives and maintaining sound risk management and internal control systems;
   (c) Reviewing the effectiveness of the risk management and internal control systems; and
   (d) Ensuring that the annual report and accounts, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the company's performance, business model and strategy.

3. Sources of assurance for the board may include:
   (a) The board's own consideration of the appropriateness and prudence of the accounting policies it has adopted;
   (b) The board's own monitoring and challenge of management's processes relating to the going concern assessment and the risk management and internal control systems and the outputs from these;
   (c) The audit committee monitoring and advising on going concern aspects of the integrity of financial reporting and the effectiveness of internal financial control;
   (d) If requested by the board, the audit committee or the risk committee advising on any of these processes or the board's overall going concern assessment;
   (e) The external auditor's communications to the audit committee about matters it considers relevant to the board and the audit committee in fulfilling their going concern responsibilities;
   (f) Reference to the work of the audit committee on going concern, in the section of the annual report dealing with its work; and
   (g) Obtaining reports on relevant matters from any compliance, risk management and internal audit functions.

Role of the board

4. The board remains responsible for identifying and evaluating significant solvency and liquidity risks, for deciding how they should be mitigated and managed[17] and for how they should be reported. It should therefore allow adequate time for these matters to be discussed[18].

5. The board also has responsibility for the financial reporting conclusions in relation to going concern in connection with the preparation of the annual and half-yearly financial statements. As these are matters related to financial reporting and internal financial control, the audit committee has a direct role in relation to these matters.

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[17] Section 2 of Internal Control: Revised Guidance for Directors on the Combined Code October 2005
[18] Principle C.2.1 of the UK Corporate Governance Code September 2012

6. As with all risk management and internal control, the board does not take on day to day responsibility for managing significant solvency and liquidity risks - that is the role of management. However, the board should ensure that there are effective forms of assurance in place to enable it to judge whether these risks have been effectively identified, evaluated, addressed, controlled and monitored, within the tolerance it establishes for them.

7. The board should ensure that its processes for reviewing the effectiveness of the risk management and internal control systems, and for enabling it to ensure that the information presented in the annual report and accounts is fair, balanced and understandable, have appropriately addressed the significant solvency and liquidity risks and the going concern information and basis of accounting in the annual report and accounts (ie to support the financial reporting purpose).

8. It should ensure that the audit committee has appropriately addressed the financial reporting aspects of going concern in fulfilling its responsibilities for monitoring the integrity of the financial statements and for reviewing the internal financial controls.

9. It should also ensure that the significant solvency and liquidity risks have been reviewed and that there is an appropriate basis on which to conclude whether the company is a going concern (ie to support the stewardship purpose).

10. The board should determine to what extent it wishes to obtain advice from the risk committee (if there is one) or from the audit committee or both. To the extent that it seeks such advice, it should be satisfied that the arrangements for the reviews carried out by those committees, for the co-ordination of their work (if both committees are involved) and for reporting to the board, including escalation of significant issues on a timely basis, are appropriate and operating effectively.

11. The board should be satisfied that regular risk monitoring and escalation reports from management, as well as other reports about the effectiveness of the risk management and internal control systems relevant to significant solvency and liquidity risks (for example, from the risk management, compliance and internal audit functions), are provided to the board (or to the audit or risk committees as appropriate).

12. The board, with the advice of the committees as it considers appropriate, should evaluate the risk reports from management and others to provide a balanced assessment of:
   - (a) any significant solvency and liquidity risks facing the company;
   - (b) the effectiveness of the system of risk management and internal controls designed to manage those risks;
   - (c) the financial adaptability of the company; and
   - (d) the contingency planning in relation to the possible crystallisation of those risks.

Role of the audit and risk committees

13. The main responsibilities of an audit committee are set out in the FRC's *Guidance on Audit Committees*[19]. The committee should monitor the integrity of the financial statements, including the going concern disclosures and basis of accounting, and review the effectiveness of the company's internal financial controls, including those relating to the financial reporting conclusions about the going concern basis of accounting and material uncertainties.

[19] Paragraphs 4.1-4.6 of the Guidance on Audit Committees (FRC, published September 2012)

14. Many companies outside the financial services sector do not have a standalone risk committee. In some companies, the duties of the risk committee are combined with those of the audit committee whereas in many others they are retained by the board. Where there is a standalone risk committee, or a combined audit and risk committee, it may advise the board in relation to the potential significant solvency and liquidity risks if requested by the board.

15. It is for the board to determine how and to what extent it should seek advice in relation to the going concern assessment from the audit or the risk committees and how they should report back and integrate their work effectively. If the board does not seek advice from the audit committee in connection with any of the matters set out in paragraph 12, the audit committee will need to consider the work of the board or risk committee on these matters to the extent necessary to meet its financial reporting and internal financial control responsibilities.

16. In accordance with the Code[20], the audit committee should communicate its advice on the matters that fall within its responsibilities to the board and these matters should be addressed in the section of the annual report addressing the committee's work.

Role of the external auditor

17. The external auditor:
    (a) reviews the board's going concern assessment process and the work of the audit committee (and risk committee, where appropriate) relating thereto[21];
    (b) communicates to the audit committee significant matters relevant to the board's and the audit committee's responsibilities for going concern[22];
    (c) reviews the narrative reporting in the annual report in relation to going concern and concludes whether they have any reason to believe that[23]:
        a. the annual report and accounts taken as a whole is not fair balanced and understandable in that respect; or
        b. any matters relating to going concern that they communicated to the audit committee are not appropriately addressed in the annual report;
    (d) explicitly refers to their conclusions in relation to the matters described in paragraph 17(c) in their audit report, identifying and addressing deficiencies[24]; and
    (e) concludes whether the going concern basis of accounting is appropriate and whether any related disclosures and any material uncertainty disclosures are appropriate[25].

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[20] Code Provisions C.3.2 and C.3.8
[21] ISA (UK and Ireland) 570, "Going Concern" and Listing Rule 9.8.10 R(1)
[22] ISA (UK and Ireland) 260, "Communication with Those Charged with Governance", [proposed] paragraph 16-1(e).
[23] ISA (UK & Ireland) 570, "Going Concern", [proposed] paragraphs 17-2 and 17-3
[24] ISA (UK and Ireland) 700, "The auditor's report on financial statements" (Revised October 2012) – [proposed] paragraph 22C
[25] ISA (UK & Ireland) 570, "Going Concern", paragraphs 6, 9 and 17

Section 4 – Reporting on Going Concern

1. The key elements of reporting on going concern are:
   (a) The board's conclusion as to whether the company is a going concern, given in the business review in the context of the description of the company's performance, business model, strategy and principal risks and in the context of what the board has regarded as the foreseeable future;
   (b) An explanation of the rationale for that conclusion, articulating the risks that would threaten the survival of the company and how they were managed;
   (c) The board's confirmation that a robust going concern assessment process was undertaken and illustration of how it obtained assurance about that;
   (d) Confirmation in the financial statements that the going concern basis is adopted or, if not, an explanation and a description of the alternative basis adopted;
   (e) Appropriate disclosures in the financial statements about any going concern material uncertainties identified; and
   (f) Explicit conclusions in the auditor's report about the going concern assessment and reporting and an emphasis of matter paragraph when there are material uncertainties[10].

2. The narrative reporting should as far as practical stand alone in telling a clear story about the solvency and liquidity risks, about the company's ability to continue as a going concern and about the board's stewardship of the company in this respect whilst providing, and explaining, appropriate (but not excessive) links to relevant supplementary information elsewhere in the annual report and financial statements.

3. The board develops its going concern narrative reporting having regard to the requirements of the Companies Act for the business review and its responsibility under the Code to present a fair, balanced and understandable assessment of the company's position and prospects (see Appendix 2).

4. The reporting and disclosures based on the outcome of the going concern assessment process meet the two reporting purposes (see Section 1 – paragraph 4):
   (a) Stewardship – by reporting about the company's economic and financial viability, the significant solvency and liquidity risks and how they are managed and demonstrating the board's stewardship and governance of the company's ability to continue as a going concern (paragraph 1 (a) to (c)); and
   (b) Financial reporting – by giving disclosure about the going concern basis of accounting and material uncertainties and any other information necessary for the financial statements to give a true and fair view (paragraph 1 (d) to (f)).

5. The information relevant to the second of these purposes must be included in the financial statements whereas that relevant to the first is primarily included in the company's narrative report. This public reporting and disclosure ensures that the assessment of the sustainability of the business model, the significant solvency and liquidity risks and the rationale for the board's conclusion as to whether the company is a going concern are always transparent, not only when there are heightened risks.

Financial statement disclosures

6. Boards of all companies should decide whether to adopt the going concern basis of accounting and whether there are material uncertainties. There will be three reporting scenarios in relation to these matters:
   (a) The going concern basis of accounting is appropriate and there are no material uncertainties. The board should confirm it has adopted the going concern basis of accounting and make the disclosures, including those about liquidity risk, necessary to give a true and fair view; or
   (b) The going concern basis of accounting is appropriate but there are material uncertainties. The board should confirm it has adopted the going concern basis of accounting in preparing the financial statements, disclose the material uncertainties and make the other disclosures, including those about liquidity risk, necessary to give a true and fair view; or
   (c) The going concern basis of accounting is not appropriate. Such a conclusion will be very rare. The board should: disclose its conclusion; if appropriate, adopt a liquidation basis of accounting and disclose the basis of accounting adopted; and make the other disclosures, including those about liquidity risk, necessary to give a true and fair view.

Narrative reporting

7. The board's narrative reporting on going concern should stand outside the financial statements as part of the wider discussion on the company's performance, business model, strategy and principal risks. This is consistent with the view of the Panel that directors being more proactive and open in their disclosures, in periods when going concern issues do not exist, should lead to greater trust between investors and the board[26]. Investors may therefore adopt a more proportionate response to going concern issues arising (for example, when a company has difficulties staying within loan covenants).

8. The narrative reporting on going concern should be tailored to the specific circumstances of the company and avoid using standardised language which may be long on detail but short on meaningful disclosures. The fundamental approach is one of "*better not more*"[27]. This Guidance therefore does not set out definitive disclosure examples for the going concern narrative. Instead, boards should consider the key objectives of their assessment of the sustainability of the business model and should:
   (a) Set out:
      a. The board's confirmation that a robust going concern assessment was undertaken (illustrating this with reference to specific issues, rather than describing process) and how it has obtained assurance about that and of how it has interpreted the foreseeable future for the purposes of its assessment; and
      b. The significant solvency and liquidity risks that have been identified and how significant a threat they pose.
   (b) Explain why the board has concluded that the company is (or is not) a going concern, having regard to the significant solvency and liquidity risks that have been identified and how they are being managed; and
   (c) Set out:
      a. Any changes to the company's significant solvency and liquidity risks since the last annual or half-year report; and
      b. Whether these changes have arisen from changes in business strategy or other factors.

[26] The Sharman Inquiry, Preliminary Report (Paragraph 125).
[27] The Sharman Inquiry, Preliminary Report (Paragraph 15).

9. There should be some degree of continuity between the discussion of significant solvency and liquidity risks in the business review and any disclosed as material uncertainties in the financial statements. For example, users may reasonably expect that matters disclosed as material uncertainties in the financial statements would have been discussed in the business review in earlier annual or half-year reports as significant solvency and liquidity risks, unless they could not reasonably have been identified or assessed as significant solvency and liquidity risks at that earlier time.

Appendix 1

Supplementary Guidance on the Going Concern Assessment Process

The foreseeable future

1. IFRS requires the board to take into account *all available information about the future* and sets down a minimum but not a maximum period over which the board should assess the ability of the company to continue as a going concern, a period of at least one year from the balance sheet date[28]. The extent of the period of assessment remains a question of judgement for the directors based on their knowledge and experience of the company's circumstances[29]. This minimum period of assessment of one year is linked by some to the annual reporting cycle, reflecting the period over which it has been traditional to budget.

2. However, the established view in the UK and Ireland is that the period should be at least twelve months from the date of approval of the financial statements because this tracks the stewardship cycle, reflecting the period to the next date for annual reporting to shareholders. This is well-documented in the UK and Ireland accounting and auditing standards and boards should take this approach or explain why that is not appropriate.

3. Within this minimum time horizon, the directors are expected to develop a high level of confidence that the company will be able to continue as a going concern. Such an assessment should involve the development of detailed financial projections (including projected cash flows and borrowing facility utilisation with sensitivity analysis) and a focus on both liquidity and solvency risks.

4. The ability of the company to continue as a going concern can only be understood in terms of the possible future outcomes of internally and externally-driven events that have occurred or that may occur and which will determine the likely outcome of executing the strategy and business plan. These cannot be predicted with certainty.

5. Assessing the ability of the company to continue as a going concern should be embedded in the company's business planning, risk management and internal control processes and the governance established over those processes. Therefore, the quality of what the board knows about the future beyond the primary period of focus depends on the future period considered in undertaking strategic and operational business planning and risk management activities to assess and manage that outcome, exercising the standard of care generally applicable to directors in the exercise of their duties.

6. This is a matter of judgment for the board, having regard to the nature of the risks inherent in the business model, and in executing the strategy, and the board's determination of the residual liquidity and solvency risks that it will tolerate. The quality of knowledge that can be developed is limited by

[28] IAS 1 paragraph 26 states that: "management takes into account all available information about the future, which is at least, but is not limited to, twelve months from the end of the reporting period". The equivalent UK GAAP requirement is set out in FRS18 – paragraph 24 states that: "the directors take into account all available information about the foreseeable future" and paragraph 61(b) states that: "where the foreseeable future considered by the directors has been limited to a period of less than one year from the date of approval of the financial statements, that fact" (see also FRSSE paragraph 2.12).

[29] For example, FRS 18 paragraph 25 states that: "The degree of consideration necessary to make the assessment required by paragraph 23 depends on the facts in each case. When an entity has a history of profitable operations, which are expected to continue, and ready access to financial resources, detailed analysis may not be necessary. In other cases, the directors may, in making their assessment, need to consider a wide range of factors surrounding current and expected profitability, debt repayment schedules and potential sources of replacement financing. **Such considerations also govern the length of time in respect of which the assessment should be made**." [**emphasis** added]

the degree to which individual future events and conditions are predictable at all – some things will occur or evolve in ways that with foresight cannot be related to past experience and therefore cannot be predicted.

7. Whilst the minimum period of twelve months from the date of approval of the financial statements will remain the primary focus for the board's consideration of quantitative analysis, they consider all available information about the future that goes beyond this period, including any arising from the following sources.

8. *Strategic or business plans that include projections of profit, or of cash flows compared with available facilities* for any period that goes beyond twelve months from the date of approval of the financial statements (albeit potentially at a less detailed level of analysis than in the budgets).

9. The board should consider the availability of funding facilities not only in terms of the amounts and periods for which they are available but also in terms of the extent to which their availability is committed to the company. This includes considering the extent to which such commitment depends on compliance by the company with specific terms and conditions (covenants).

10. In order to take funding facilities into account in its assessment, the board should have a high degree of confidence that the company will be able to comply with any covenants and that any facilities repayable on demand or whose availability will expire during the foreseeable future will be rolled-over or renewed on appropriate terms.

11. *Qualitative and longer term consideration of solvency[4] risks* – undertaken in the identification and evaluation of the significant solvency and liquidity risks, which considers their likely evolution and impact beyond twelve months from the date of approval of the financial statements.

12. It may be difficult for a board to predict with certainty the future evolution and impact (in terms of amplitude and timing) of the effects of those risks over the general economic cycle or their own company's business cycles or the relationship between that evolution and the company's business success. However, boards use their judgement and their business skills and experience to consider how those risks may evolve over those periods, in order to recognise and plan for possible changes that can reasonably be anticipated, given past cyclicality and trends, the current position in the general economic cycle and the dynamics of its own industry and business cycles.

13. *The results of prudent stress tests of the significant solvency and liquidity risks* that have been undertaken and that go beyond twelve months from the date of approval of the financial statements (see paragraphs 26 to 37).

Solvency and liquidity risks

Economic and financial distress

14. The principal threats to the ability of the company to continue as a going concern are the onset of economic or financial distress. Economic distress is characterised by sustained weak or negative profitability judged over the longer term (below the long term cost of capital) and may be symptomatic of a weak or failing business model or strategy or their execution, whatever the root cause. Underlying causes may include, for example, changes in the business model, in the dynamics of competition, in relationships with customers and suppliers or in substitute products or services. Care is needed in judging whether financial measures over the shorter term merely reflect short term performance or are indicative of sustained economic value issues.

15. Financial distress may be distinguished from economic distress. Financial distress occurs when there are serious questions about the entity's ability either to meet its liabilities in full (an outright problem irrespective of timing – a failure of ***solvency***[4]) or to meet them when they fall due (a timing issue, often relatively short term – a failure of ***liquidity***[5]).

16. If not addressed, economic distress may over time erode or devalue capital and lead to financial distress, and ultimately to failure, but an entity may survive for some time with such factors at play without evident financial distress. Financial distress (in particular liquidity difficulties) can also occur without economic distress but often leads to economic distress as financial support and resources may be withdrawn from the entity or the cost of finance may increase to a point where it cannot be sustained by the business model.

17. There are many potential causes of distress and failure – both internally and externally-generated. These do not necessarily operate independently of each other. For example, weak management may be an underlying cause of economic distress but it could continue for some time without becoming evident, leaving the entity more vulnerable to an external shock.

18. Distress is a dynamic process the onset of which may vary in severity and which may continue for some time until it is resolved – one possible outcome is failure but the company also has the opportunity to recognise and respond to the causes of distress and hence to recover. Whether the business model of an entity is sustainable is not therefore a binary condition (financially healthy or not) and good stewardship is more often about avoiding or managing distress than imminent failure.

The need for a focus on both solvency and liquidity in assessments of the ability of the company to continue as a going concern

19. Solvency and liquidity are both important gauges for assessing the ability of the company to continue as a going concern.

20. Liquidity risk relates to the ability of a company to meet its liabilities as they fall due and liquidity difficulties therefore primarily relate to cash flow problems or problems with access to financing facilities. Considerations relating to these aspects of going concern have been the primary focus of many assessments in the past, undertaken with a time horizon of at least 12 months from the date of the assessment.

21. Solvency risk is about the sustainability of a company's business model and the maintenance of its capital. It underpins the longer term ability of the company to obtain and maintain debt funding as well as equity capital for the business. It is important to understand how the likely future success of the business will be perceived by providers of equity, debt and trade credit in assessing likely access to funding and liquidity (for example, doubts about the future success of a company's business model could result in short term funding becoming harder, or even impossible, to obtain)[30].

22. An effective assessment of a company's solvency therefore considers the longer term and is based more on qualitative than quantitative factors (such as where the company is in its own business

[30] In effect, it is the market-perceived value of the assets and liabilities of a company (assuming that they are realised and settled in the normal course of business), not the accounting book values, that defines the solvency of the entity. This value includes the value of intangibles including any anticipated future capacity to earn a return in excess of the cost of capital. If the entity has a deficit of assets on this measure, the holders of equity have no value in the business and are unlikely to provide funding as their capital would first be absorbed by the cumulative losses. No new provider of debt is likely to be available either, except on a preferred basis, because the existing debt cannot be paid from the perceived value of the assets and it may be necessary for existing debt to swap for equity.

cycles and how they fit with the general economic cycle). A significant focus on solvency risk in going concern assessments has been less common outside the financial services industry than the focus on liquidity risk and is an area where this Guidance urges boards to increase their focus.

Symptoms of severe distress

23. A board facing significant economic or financial distress, may have no realistic alternative but to take actions outside the normal course of business to raise or renegotiate finance, materially curtail the entity's operations, or realise its assets or discharge its liabilities. Taking such actions may have significant consequences for the company's business and stakeholders and there may well be considerable uncertainty associated with the availability or likelihood of effectiveness of such actions. The need to take such actions is therefore usually symptomatic of severe distress.

24. What is or is not outside the normal course of business is a matter of judgment. Financial adaptability and contingency planning (for example, maintaining contingent borrowing facilities or making contingency plans to maintain profitability when identified risks that have been tolerated arise) is a normal part of business planning to enable the entity to survive reasonably anticipated shocks.

25. This may be contrasted with crisis management, which involves establishing effective systems to deal with severe shocks that were not or could not have been reasonably anticipated. Both effective contingency planning and effective crisis management systems may be important elements of an entity's response to risks that threaten the ability of the company to continue as a going concern.

Stress testing and sensitivity analysis

26. Stress tests and sensitivity analysis are both simulation techniques used to gauge how changes in economic and financial circumstances would affect a particular company. Sensitivity analysis tends to be undertaken by flexing individual variables, or sometimes combinations of variables, in a model that projects the expected performance or financial outcome for a business. This may help in assessing both the company's financial adaptability and the significance of particular variables to the projected financial outcome.

27. Stress tests apply a more holistic approach by projecting the expected performance or financial outcome for a business in different scenarios. They are designed to test the resilience of the business to severe but plausible scenarios. Although financial institutions have undertaken stress testing for a number of years, with its use subject to regulatory guidance[31], its application in other industrial sectors is less common.

28. The Panel concluded that stress testing offers a valuable means by which directors of all companies, whatever their industry, could assess solvency and liquidity risks[32]. The use of stress tests should help directors to assess the economic and financial conditions in which potentially significant solvency and liquidity risks may crystallise. Reviewing different strategic scenarios may assist boards in identifying such risks.

29. Boards may also find the use of reverse stress testing assists in understanding the potential impact of severe economic or financial distress on solvency and liquidity. Reverse stress-testing starts from a hypothetical outcome of business failure (a failure of solvency or a failure of liquidity) and identifies

[31] For example, the FSA's Policy Statement 09/20, Stress and scenario testing (issued December 2009) or the Basel Committee on Banking Supervision's Principles for sound stress testing practices and supervision (issued May 2009),
[32] The Sharman Inquiry, Final Report (Recommendation 3c).

scenarios in which this might occur. The purpose of undertaking such tests is to identify what could cause the business to fail and to use this information to ensure that the relevant risks are sufficiently well-understood and appropriately managed to secure the success of the company.

30. Effective stress tests should engage senior management and the directors in the process and have the potential to provide them with a company-wide view of the impact of risks on the business.

31. This Guidance does not set down a list of prescribed stress tests for directors to undertake. Rather, the board should consider the individual circumstances of its own company and tailor stress tests best suited to its business model, strategy and current position and level of performance.

Prudence in stress testing

32. Stress tests of liquidity and solvency should be undertaken with an appropriate level of prudence. Prudence is a general concept which involves weighting downside risks more heavily than upside opportunities. It has wider application than merely adopting prudent measurement or recognition policies in the financial data which underpins the financial model.

33. A bank's lending policy, for example, may be more or less prudent depending on the diligence with which it assesses the risk of credit losses or the level of tolerance of higher risks in that policy. Therefore, the level of prudence in the lending policy itself has consequences for the quality of the assets a bank holds and for its solvency.

34. However, a less prudent lending policy may be offset by a more prudent minimum capital policy and/or by a more prudent capital measurement policy (whether or not this is reflected in the measurement and recognition policies for assets and liabilities in the financial statements). Simply considering prudence from a financial reporting perspective in modelling may therefore risk missing the relevance of prudence in other important elements of the overall solvency position.

35. In undertaking stress tests on solvency and liquidity, the directors should take an integrated approach to the application of prudence in their assessment of the impact of all the significant solvency and liquidity risks and the related mitigating strategies put in place by them. This might include, for example, considering the downside impact of the following.

36. *Risks relating to past causes* that may yet give rise to future effects that are not, or not yet adequately, reflected in the measurement and recognition of assets and liabilities in the financial statements that underlie the solvency model. The board should consider whether reported capital is adequately discounted for these risks, and what impact recognition would have on solvency. Examples may include: measurement uncertainty; economic mismatches between the timing of revenue, and cost or loss, recognition; the risk that fair values of assets may reflect exuberant market conditions that are unrealistic in the longer term; and latent or inherent risks arising from less prudent past business policies or practices or from lax past legal or regulatory compliance.

37. *Risks relating to future events or changes in the environment* in which the company operates. Examples may include: borrowing facilities may not be available in future for the same amounts as in the past, or may not be available on the same terms; the effects of future economic conditions on business volumes and margins; credit risk; liquidity risk; other market risk; and the effects of other tolerated (residual) risks.

Appendix 2 – Relevant Regulatory Requirements

1. The key regulatory requirements for a Code Company in connection with the assessment of and public reporting about going concern are:

Companies Act 2006

2. Section 172 of the Act requires that "*A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole…*". A key aspect of promoting success will be seeking to ensure that the business model is sustainable, within the risk tolerance established by the board. Unless a company remains viable, it will not be able to achieve that success by generating and preserving value for its stakeholders.

3. Section 417 of the Act requires that the directors prepare a business review[33] whose "*purpose … is to inform members of the company and help them assess how the directors have performed their duty under Section 172. The business review must contain:*
   (a) a fair review of the company's business, and
   (b) a description of the principal risks and uncertainties facing the company".

4. Directors are required to prepare accounts in accordance with an applicable accounting framework. Under the Act, this must either be IFRS[34], or UK GAAP[35] and the requirements of the Companies Act[36].

The Code

5. The Code adopts a "comply or explain" approach, meaning that a board should either comply with the principles of the Code or, where it does not, should provide a clear rationale for why it has not done so. Key aspects of the Code that are relevant to the board's responsibility for stewardship of the ability of the company to continue as a going concern include:
   (a) "*The board is responsible for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives. The board should maintain sound risk management and internal control systems*". (Principle C.2)
   (b) "*The board should, at least annually, conduct a review of the effectiveness of the company's risk management and internal control systems and should report to shareholders that they have done so. The review should cover all material controls, including financial, operational and compliance controls*". (Provision C.2.1)
   (c) It is the responsibility of the audit committee "*to review the company's internal financial controls and, unless expressly addressed by a separate board risk committee composed of independent*

[33] The Future of Narrative Reporting, *A New Structure for Narrative Reporting in the UK* (BIS, October 2012), proposes a separate strategic report to replace the business review. Listed companies will be required to report, as necessary for understanding of the business, on their strategies, business model and any human rights issues. The regulations, coming into force in October 2013, will cover broadly the same content as the review required under Section 417.

[34] IAS 1, paragraph 25 – "An entity shall prepare financial statements on a going concern basis unless management either intends to liquidate the entity or to cease trading or has no realistic alternative but to do so."

[35] FRS 18, paragraph 21 – "An entity should prepare its financial statements on a going concern basis, unless (a) the entity is being liquidated or has ceased trading, or (b) the directors have no realistic alternative but to liquidate the entity or to cease trading …"

[36] The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008, Schedule 1, Part 2, Section A, paragraphs 10 to 15 requires the amounts included in a company's accounts to be determined in accordance with the principle that the company is presumed to be carrying on business as a going concern unless there are special reasons for departing from that principle.

directors, or by the board itself, to review the company's internal control and risk management systems". (Provision C.3.2)

(d) *"The board should present a fair, balanced and understandable assessment of the company's position and prospects."* (Principle C.1)

(e) "*The directors should include in the annual report an explanation of the basis on which the company generates or preserves value over the longer term (the business model) and the strategy for delivering the objectives of the company*". (Provision C.1.3)

(f) "*The directors should report in annual and half-yearly financial statements that the business is a going concern, with supporting assumptions or qualifications as necessary*". (Provision C.1.3)

The UK Listing Rules

6. The annual report for a premium listed company must include "*A statement made by the directors that the business is a going concern, together with supporting assumptions or qualifications as necessary, that has been prepared in accordance with Going Concern and Liquidity Risk: Guidance for Directors of UK Companies 2009, published by the Financial Reporting Council in October 2009*". (Listing Rule 9.8.6R(3)[37])[38]

7. The auditor is required to review the statement by the directors that the business is a going concern (Listing Rule 9.8.10 R(1)).

FSA Disclosure Rules and Transparency Rules (DTR)

8. "*The corporate governance statement must contain a description of the main features of the issuer's internal control and risk management systems in relation to the financial reporting process*". (DTR 7.2.5 R)***.***

Auditing Standards (UK and Ireland)

9. "*The auditor's responsibility is to obtain sufficient appropriate audit evidence about the appropriateness of management's use of the going concern assumption in the preparation and presentation of the financial statements and to conclude whether there is a material uncertainty about the entity's ability to continue as a going concern*". (ISA 570 (UK and Ireland), Going Concern)

[37] The equivalent reference in the Irish Listing Rules is Section 6.8.3(3).

[38] [Discussions to be held with UKLA to discuss update to refer to this revised Guidance]

Glossary of Abbreviated Terms

BBA	British Bankers' Association
BIS	Department of Business, Innovation and Skills
Code	UK Corporate Governance Code, published by the FRC in September 2012
EBA	European Banking Authority
EDTF	Enhanced Disclosure Task Force, established by the Financial Stability Board
ELA	Emergency Liquidity Assistance
FRC	Financial Reporting Council
FRS	Financial Reporting Standard
FRSSE	Financial Reporting Standard for Smaller Entities
FSA	Financial Services Authority
FSB	Financial Stability Board
Guidance	The [Provisional] Guidance on Going Concern, January 2013
IAASB	International Auditing and Assurance Standards Board
IASB	International Accounting Standards Board
ICB	Independent Commission on Banking
IFRS	International Financial Reporting Standards
ISA	International Standard on Auditing
Panel	Sharman Panel of Inquiry into Going Concern and Liquidity Risks
PRA	Prudential Regulatory Authority
SRR	Special Resolution Regime for banks introduced under the Banking Act 2009
UK GAAP	UK Generally Accepted Accounting Practice
UKLA	UK Listing Authority – The FSA acting as the competent authority under Part VI of the Financial Services and Markets Act 2000

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Guidance on Going Concern
Supplement for Banks

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Contents

Preface

This Supplement, which addresses supplementary considerations for the banking sector, should be read in conjunction with the Guidance on Going Concern issued in [January 2013]. The Guidance and this Supplement reflect the recommendations of the Sharman Panel of Inquiry into *Going concern and liquidity risks: lessons for companies and auditors*[39] and replace *"Going concern and liquidity risk: Guidance for directors of UK companies 2009"*. The Panel was commissioned in the aftermath of the financial crisis to identify lessons for companies and auditors addressing going concern and liquidity risks and recommend any necessary improvements to the existing reporting regime and guidance for companies and auditors in relation to these matters.

The Panel addressed the particular issues relating to the going concern risks affecting banks. This Supplement provides background information explaining the context of going concern assessments and reporting for banks. It also provides supplementary guidance in relation to the identification and reporting of material uncertainties in the financial statements and in relation to the context for reporting about significant solvency and liquidity risks in the case of a bank.

This Supplement applies to all banks and their boards insofar as it addresses their Companies Act [or similar] narrative and financial reporting responsibilities. For banks that are required, and those that choose voluntarily, to report on how they have applied the Code, it also applies in addressing the further reporting requirements applicable to such banks under the Code.

This Supplement will also be useful in assisting others, such as shareholders and auditors, to understand the context of the going concern responsibilities of a bank's board following implementation of the recommendations of the Panel.

This Supplement is based on the legislation and regulations in force at 1 January 2013. It does not contain an exhaustive list of the obligations that banks and their auditors may have under the Financial Services and Markets Act, the FSA Handbook or other relevant legislation or regulations.

We are very grateful to the Bank of England for providing information about its role and responsibilities in developing this Supplement.

The Guidance and this Supplement are applicable for financial years commencing on or after 1 October 2012 but early adoption is encouraged.

[39] See http://www.frc.org.uk/Our-Work/Headline-projects/The-Sharman-Inquiry.aspx

Section 1 – Introduction and Background

Introduction

1. The crisis affecting the banking sector that began in 2007 led to questions about whether banks should be treated differently from other companies in terms of the public disclosure regime that should apply to them and their auditors resulting from their going concern assessments. These questions arose from potentially conflicting public interests, given that banks' business models intensify their exposure to solvency and liquidity risks due to the maturity transformation that they undertake – as a result, the sustainability of their funding models is highly dependent on confidence in their solvency and liquidity.

2. There is a strong public interest in limiting systemic damage from bank failure – the financial transactions they facilitate underpin the smooth functioning of economic activity and their lending role supports economic growth. The key issue for banks is that in practice any signalling of uncertainties about their solvency or liquidity may undermine confidence in their ability to repay their debts and trigger a run on the bank.

3. In order to protect the public interest, one critical ingredient of the authorities' toolkit includes providing banks with liquidity insurance facilities to mitigate the temporary effects of system-wide or entity-specific liquidity shocks experienced by solvent and viable banks. However, there would also be a moral hazard in protecting banks at all costs. The Bank of England, amongst others, is responsible for protecting and enhancing the stability of the UK financial system. It works within a balanced framework which recognises not only the importance of stability but also that the possibility of failure engenders market discipline.

4. Where liquidity assistance can be justified, it is provided whilst seeking to avoid rewarding commercial failure. Protection from solvency issues arising from poor commercial performance cannot normally be justified and, when a bank is judged not to be solvent or viable, the regulatory objective is to minimise the impact of that failure on the financial system and the economy.

5. On the other hand, there is also a public interest in maintaining efficient markets for banks' capital, just as there is for other companies' capital, as this supports their investibility. Transparency is critical for achieving market efficiency – the requirements for annual and half year reports (including financial statements) and other obligations under the Listing Rules, the Disclosure and Transparency Rules and the Prospectus Rules of the UKLA seek to achieve that.

6. Where these public interests have been seen potentially to conflict was in relation to the question whether the actual or expected need for central bank liquidity insurance facility usage by a bank should be publicly disclosed in the interests of market transparency. Many believe that premature disclosure of such usage would almost inevitably give rise to a self-fulfilling prophecy and lead to a run on the bank. That prospect would simply force the hand of the authorities to refer the bank into the SRR, even in circumstances where this could have been avoided through deploying the liquidity insurance facilities available to a bank that is judged to be solvent and viable. The question raised is whether the public interest objective of financial stability should ever override the public interest objective of transparency in capital markets?

7. The Panel concluded that this was not necessary and set out the Panel's vision of how these objectives may be reconciled within the current framework for public disclosure about significant solvency and liquidity risks applicable to all companies and their auditors. The Guidance and this

Supplement implement the recommendation of the Panel that the FRC should make clear that use of liquidity insurance provided by central banks may be a normal source of funding for a bank that is judged to be solvent and viable and that, if so, the need to use those facilities does not necessarily mean that the bank is unable to continue as a going concern or that there are material uncertainties that need to be publicly disclosed by the bank and emphasised by its auditor.

8. The fundamental approach to significant solvency and liquidity risks and related public reporting by banks is consistent with the general approach described in the Guidance. However, the remainder of this Supplement explains how that approach is applied by banks in the context of: their exposure to potentially more intense solvency and liquidity risks; their greater vulnerability to confidence in the sustainability of their funding models; and the need for close co-operation between banks, their supervisors and their auditors in relation to these matters in the context of the significantly enhanced regulatory regime for monitoring and addressing these issues that has emerged in the aftermath of the financial crisis.

More intense liquidity and solvency risks and greater vulnerability

9. The business model of many banks involves performing the financial intermediation role known as maturity transformation – on the whole, channelling collective funds obtained through shorter term borrowing into longer term loans and investments. This creates a maturity mismatch between the dates on which the bank's liabilities fall due for payment and the dates on which it can call for repayment of its assets. This makes banks' funding models inherently unstable.

10. Confidence in a bank's solvency is what sustains this business model. Depositors and other lenders roll over their loans to the bank, or other lenders replace them, when they are confident that the bank will continue to be solvent and viable. On the other hand, fear about the future viability and solvency of the bank may provoke expectations of delayed repayment or non-repayment and may result in withdrawal of loans by existing lenders as well as deterring others from replacing them. Gearing, wholesale market-based funding models, off-balance sheet exposures and other complexities in banks' operating models may further exacerbate these fears.

11. For example, because banks are highly geared, relatively small changes in the value of their risk assets would have a much more significant proportional effect on their net asset value, due to the multiplier effect of the gearing. Small changes in these values can therefore have quite significant impacts on net asset values.

12. Given that a bank has limited liquid resources compared to its liabilities, a run results from knowledge that its liquid assets will be insufficient to fund repayment to all lenders when due if called, exposing those who linger to increased risk of delayed repayment and a greater share of the risk that losses on the remaining assets will exceed capital. A bank's business model would likely not be sustained in these circumstances and it will likely fail. In the banking business, such failure can be infectious and rapidly spread to other banks.

13. The interconnectivity of transactions and obligations between banks underpins the banking system. The failure of one bank can therefore cause shocks in a number of other banks, and this propagation of shocks can have a serious impact across the whole banking network.

Co-operation between banks, supervisors, the Bank of England and auditors

14. In addition to their stewardship responsibilities for the going concern status of the bank, boards of banks have to meet both their regulatory and market transparency obligations in relation to

monitoring, managing and reporting their solvency and liquidity risks. In forming their judgments, boards of banks consider the scale and likelihood of the threats to the bank's going concern status.

15. The auditors address these matters in meeting their audit responsibilities to consider how they are dealt with in the annual report and financial statements as well as in meeting their duty, and exercising their right, to report to the regulator in fulfilling that responsibility.

16. The Bank of England and the FSA (and in future the PRA will) have responsibility for interpreting the scale of the threat arising from these risks in the context of their financial stability and prudential supervision objectives.

17. The need for co-operation between banks, supervisors, the Bank of England and auditors in relation to banks' liquidity and solvency risks arises primarily because there is a strong mutuality of interest between these parties in relation to understanding the assessment and management of the solvency and liquidity risks being faced and taken by the banks – and they can each contribute to the others' understanding. Although their duties and responsibilities are in some respects different, they overlap in others and there are legal and regulatory obligations for them to co-operate[40] in fulfilling them.

18. Examples of the ways in which co-operation can provide mutual benefit include the following:
    (a) Supervision is enhanced by obtaining information about the banks' exposure to such risks and the directors' plans for addressing them received through interaction with the directors and key management of the bank as well as the auditors;
    (b) The board and auditors benefit from understanding the regulators' perception of the risks the bank is taking and facing, including those in the wider financial system; and
    (c) The board benefits from challenge to their assessment of, and plans for managing, these risks by supervisors and auditors; auditors may provide boards with one source of assurance about the robustness of their assessment and its outcome, including the quality of their reporting.

19. In fulfilling their duty to promote the success of the company, the directors are responsible for the stewardship of the company's going concern status. They should focus on those risks, or combinations of risks, that can so seriously damage the sustainability of the company's cash flows, performance or future prospects that they may give rise to severe economic or financial distress. In doing so, their duty is not limited because the regulator sets minimum requirements either for their assessment process (eg specifying minimum stress testing) or for minimum risk mitigation (eg specifying minimum regulatory capital).

20. As the Panel noted in its preliminary report:

    "The responsibilities of the directors of banks are not simply met by placing reliance on the minimum regulatory benchmarks but by being on top of their going concern assessment all year round by living and breathing it".[41]

[40] See FSA Code of Practice for the relationship between the external auditor and the supervisor May 2011; ISA 250 (UK&I) Section B The Auditor's Right and Duty to Report to Regulators in the Financial Sector – paragraphs A1 to A8; Practice Note 19 The Audit of Banks and Building Societies in the United Kingdom – paragraphs 57 to 97 and Appendix 5

[41] The Sharman Inquiry, Preliminary Report, Paragraph 224.

Banking reforms relevant to solvency and liquidity

21. Following the financial crisis, wide ranging reforms have been, and are still being, introduced, that are designed to build the resilience of banks. These are all likely to be relevant to the assessment of significant solvency and liquidity risks for banks. They include the following developments.

Governance requirements

22. <u>*Separate risk committees*</u> – the Walker report recommended that FTSE 100 financial services companies should have a separate Risk Committee.

23. In many non-financial companies risk governance will form part of the overall responsibilities of the audit committee or may be undertaken directly by the Board. In the banking sector, separate risk committees review, and report their conclusions to the board, on:
    (a) The bank's risk appetite and tolerance (ie the extent and categories of risk which the board regards as desirable and/or acceptable for the company to bear); and
    (b) The bank's risk management framework (for example, covering principles, policies, systems, processes, procedures and people).

24. The board will therefore need to review the work of the Committee in relation to significant solvency and liquidity risks and provide challenge in assessing the quality of the assurance the board has obtained in adopting and responding to the Committee's conclusions and how these are integrated with other inputs to the going concern assessment.

25. <u>*Recommendations of the Independent Commission on Banking*</u> *– the UK Government has* published the Financial Services (Banking Reform) Bill, to implement the recommendations of the ICB, with the legislation intended to be finalised by 2015 and implemented by 2019. The aim is to develop a more resilient, stable and competitive banking sector.

26. Key elements of these proposals include introducing a ring-fence to separate investment banking activities from the more traditional retail banking. The latter ring-fenced business would have its own board and risk committee. Other proposals focus on how to ensure that the ring-fenced bank has sufficient capacity in its capital structure to absorb losses to make banks more resilient to shocks and more resolvable and hence to reduce financial stability risks. These include increasing the level of equity held in relation to the value of risk-weighted assets and introducing a bail-in tool, a binding leverage ratio and measures, such as preferring insured depositors, to ensure that losses fall on those best placed to assess bank risks.

27. As these proposals develop they are likely to have significant implications for the going concern assessment and reporting both for bank holding groups with such ring-fenced banks and for the ring-fenced banks themselves.

Minimum regulatory requirements for banks

28. <u>*More intense stress testing regimes*</u> – there are three elements to the stress testing regime: firms' own firm-wide stress tests of capital and liquidity and reverse stress tests (including assessing the adequacy of capital buffers to enable the bank to meet the minimum capital requirements at all times); supervisory stress tests of particular entities, which are firm-wide; and simultaneous supervisor led system-wide tests, the results of which are not generally published. In addition to the FSA's stress tests, the EBA co-ordinates EU-wide stress tests as a supervisory tool designed to assess the

resilience of European banks, as necessary – these are applied to banks covering a significant proportion of EU-wide banking assets and aggregated.

29. Reverse stress-tests require a bank to assess scenarios and circumstances that would render its business model unviable. A firm's business model is described as being unviable at the point when crystallising risks cause the market to lose confidence in the firm.

30. The results of each of these ranges of tests are relevant to a bank's assessment of its resilience to stress. A bank should not take unreasonable comfort from the results of stress testing against supervisory determined stress scenarios. The ultimate responsibility for setting appropriate scenarios to stress test rests with the bank.

31. *Individual bank Recovery and Resolution Plans* – requirements for banks to prepare Recovery and Resolution Plans are being developed by the FSA. These should assist banks to anticipate and build action plans for recovery from shocks as well as assisting the authorities in monitoring the triggers for implementing such plans and in executing the resolution of the bank in the event of failure. The draft core rules have been published[42] based on the experience gained from pilots.

32. The aim in finalising them is to seek to ensure that the final plans are internationally coordinated and aligned with other regulatory initiatives, including: the Key Attributes of Effective Resolution Regimes published by the FSB; the European Commission initiative on bail-in and a directive to establish a framework for recovery and resolution; and the ICB's proposals and the government response to them.

33. *FSA's liquidity regime* – the reformed rules are designed to enhance firms' liquidity risk management practices, based on lessons learned since the crisis began in 2007. They include quantitative requirements, with a narrow definition of liquid assets. There are also qualitative requirements which include: over-arching principles of self-sufficiency and adequacy of liquid resources; enhanced systems and controls requirements; granular and frequent regulatory reporting requirements; and a regime for foreign branches that operate in the UK.

Framework for regulatory response

34. *Proposed Proactive Intervention Framework* – the Proactive Intervention Framework[43] is part of the PRA's proposed monitoring and mitigating of risks to the safety and soundness of individual firms and sets out how and when the PRA will escalate its engagement as risks to a firm's viability increase. This is part of the PRA's move to forward-looking, proactive, judgment-based supervision under the regulatory reform programme. The overarching objective will be to seek to ensure the safety and soundness of firms and to avoid disorderly failure which has systemic consequences.

35. *Major overhaul of the Bank of England's liquidity insurance facilities* – the primary responsibility for the prudent management of a bank's liquidity risk lies with the bank's directors and the costs of poor management in this regard primarily lie with its shareholders. Banks hold liquid assets such as high quality assets that can be exchanged rapidly for money in liquid markets as self-insurance against liquidity shocks.

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[42] See: http://www.fsa.gov.uk/pubs/discussion/fs12-01-draft-rules.pdf

[43] See joint paper issued by the Bank of England and the FSA: The Bank of England, Prudential Regulation Authority – Our approach to banking supervision – May 2011: http://www.bankofengland.co.uk/publications/other/financialstability/uk_reg_framework/pra_approach.pdf

36. However, the Bank of England also provides a range of liquidity insurance facilities for banks. The Bank of England's principal liquidity insurance facilities are part of the Bank's Sterling Monetary Framework, which is described in the "Red Book"[44]. Access to the Bank's liquidity insurance facilities is designed not to undermine banks' responsibility prudently to manage their solvency and viability.

37. Access is also designed not to undermine the incentives for banks to manage their liquidity risk prudently in the market. Hence, an overarching condition of access is that the bank must be judged to be solvent and viable by the Bank of England, when it lends under the facility. When the Bank lends in its operations, it does so against collateral of sufficient quality and quantity to protect itself from counterparty credit risk. Furthermore, pricing of these facilities is designed to incentivise prudent liquidity management.

38. The Bank of England offers several facilities to provide liquidity insurance to the banking system as a whole. The Indexed Long-term Repo (ILTR) facility allows banks to bid for liquidity in the form of central bank reserves for maturities of three and six months. The Extended Collateral Term Repo (ECTR) is a contingent facility which allows banks to bid for central bank reserves against a wider range of collateral than the ILTR and includes portfolios of "raw" (unsecuritised) loans. Both the ILTR and ECTR operate through pre-announced market-wide auctions in which central bank reserves are allocated to banks according to the bids they offer.

39. However, the Bank also provides liquidity insurance against entity-specific liquidity shocks. The Discount Window Facility is available on-demand on a bilateral basis, rather than only when a market-wide operation is scheduled. It is designed to provide liquidity normally up to 30 days which can be rolled over at the Bank's discretion. It is intended to act as a bridge facility, only being advanced when there is a credible path to a point where access is no longer required. It is structured as a swap of lower liquidity assets for high liquidity gilts which banks can then exchange for money in the markets. The range of collateral accepted is the same as for the Extended Collateral Term Repo facility.

40. These are the principal, permanent liquidity insurance facilities offered by the Bank of England. They are in the Bank of England's published frameworks and are designed to be offered on (collateralised) terms only to banks that are considered by the Bank of England to be both solvent and viable.

41. Beyond this, there are some more exceptional ways in which a bank in difficulty may receive assistance from the Bank of England or HM Treasury. Decisions involving public funds are the sole responsibility of the Chancellor and HM Treasury. The Financial Services Act clarifies the way in which such support is provided and who is in charge of what, and when, in the course of future financial crisis management[45]. In addition to the published facilities described above, the following may be provided:
    (a) Emergency Liquidity Assistance (ELA, defined as support operations outside the Bank's published frameworks) to firms that have a sufficient probability of future insolvency, but which have some prospect of action to make them solvent, either at the Bank of England's proposal and subject to Treasury authorisation or on terms other than proposed by the Bank of England, if so directed by the Chancellor;

[44] The most recent version of the Red Book can be found at: http://www.bankofengland.co.uk/markets/pages/sterlingoperations/redbook.aspx

[45] See: *A new approach to financial regulation: securing stability, protecting consumers*, presented to Parliament by the Chancellor of the Exchequer by Command of Her Majesty, January 2012 at: http://www.hm-treasury.gov.uk/d/fin_fs_bill_policy_document_jan2012.pdf (see especially Appendix E – MOU on crisis management)

(b) ELA in a support operation going beyond the Bank's published frameworks to firms that are ***not judged*** by the Bank of England to be solvent and viable, if so directed by the Chancellor; and
(c) Special support operations for the financial system as a whole, going beyond the Bank's published frameworks, when so directed by the Chancellor.

42. Similar to the Discount Window Facility, the Bank of England would only make an advance without direction or guarantee when in their view there is a credible path to a point where access is no longer required. If the Chancellor directs the Bank of England to carry out a support operation, the Bank of England acts as agent of HM Treasury, setting up a special purpose vehicle to carry out the support operation. Such a vehicle would be indemnified by HM Treasury.

43. *Special Resolution Regime* – a bank's entry into the SRR is triggered when the FSA (or in future PRA) judges that the bank is failing or is likely to fail to meet the threshold conditions of authorisation and that it is not reasonably likely that alternative action will be taken by the bank that would enable it to satisfy those conditions[46]. The threshold conditions, which must be met by a bank both upon authorisation and on an on-going basis, include amongst others that it has sufficient liquidity and capital resources.

44. In effect, these conditions mean that reliance on Government support or on other than ordinary market assistance by the Bank of England, without which the bank would, or would be likely to, fail to meet the FSA's threshold criteria – would normally result in resolution powers being used or some other action of the sort being described in paragraph 41 being taken. Once a resolution power has been used, the Bank of England is required to make a public disclosure as soon as is reasonably practicable.

45. The concept of 'ordinary market assistance' is judgmental. As explained in the *Special Resolution Regime: Code of Practice*[47], the Bank of England provides banks with a spectrum of assistance in all types of different circumstances. Whether or not financial assistance from the Bank of England constitutes "ordinary market assistance... on its usual terms" will depend on a combination of factors, including the terms of the Bank's operation, the circumstances of the bank receiving liquidity from the Bank, and conditions in the relevant markets in which the firm was, or would otherwise be, seeking to access funding. Furthermore, these factors may vary during the period that any assistance is given.

46. Regulatory tools to address the problems once the SRR has been triggered fall into two categories, stabilisation tools and a new special insolvency regime for winding up banks (the *Bank Insolvency Procedure*).

[46] The conditions under which such referral should occur is set out in the Banking Act 2009, Section 7, sub-sections (2) to (4):
(2) Condition 1 is that the bank is failing, or is likely to fail, to satisfy the threshold conditions (within the meaning of section 41(1) of the Financial Services and Markets Act 2000 (permission to carry on regulated activities)).
(3) Condition 2 is that, having regard to timing and other relevant circumstances, it is not reasonably likely that (ignoring the stabilisation powers) action will be taken by or in respect of the bank that will enable the bank to satisfy the threshold conditions.
(4) The FSA shall treat Conditions 1 and 2 as met if satisfied that they would be met but for financial assistance provided by—
(a) the Treasury, or
(b) the Bank of England (disregarding ordinary market assistance offered by the Bank on its usual terms).

[47] See http://www.hm-treasury.gov.uk/d/bankingact2009_code_of_practice.pdf

Risk reporting

47. *BBA Code for Financial Reporting Disclosure* – the Turner Review[48] highlighted questions that the financial crisis had raised about the adequacy of financial disclosure by banks (particularly for complex financial instruments held by them) and the level of confidence that investors could place in their financial reports. In response, the BBA developed a voluntary code of disclosure, based on principles and supplementary guidance, and in October 2009 announced that the major UK-headquartered banks had agreed to adopt it. Following consultation by the FSA, and amendments made to the BBA Code in light of experience of applying it in 2009, it was finalised in 2010.

48. The BBA Code goes beyond the disclosure requirements of the accounting standards and capital markets disclosure requirements. It is based on an overarching principle that UK banks are "committed to providing high quality, meaningful and decision-useful disclosures to users to help them understand the financial position, performance and changes in the financial position of their businesses". It recognises that that there is a level of public interest in their disclosure that extends to other stakeholders in addition to investors.

49. *Financial Stability Board Enhanced Disclosure Task Force Report* – in October 2012, the FSB's Enhanced Disclosure Task Force published its report setting out principles and recommendations for improved bank risk disclosures and leading disclosure practices designed to provide timely information useful to investors and other users and in time to improve market confidence in financial institutions.

[48] See: http://www.fsa.gov.uk/pubs/other/turner_review.pdf

Section 2 – Supplementary Guidance

Addressing the implications of central bank and government assistance

Introduction

50. The interpretation of what constitutes a material uncertainty under the accounting standards is a matter of judgment. In the Guidance and this Supplement, consistent with the recommendation of the Panel, the interpretation adopted is that reliance on central bank and government liquidity assistance does not necessarily mean that the bank is not a going concern or that a material uncertainty should be disclosed.

51. The following paragraphs address the circumstances in which reliance upon central bank or government assistance for a bank would or would not signal a material uncertainty, the necessary considerations in arriving at a conclusion on this matter and the reporting and other implications of such a conclusion.

Reliance on liquidity insurance

52. Paragraphs 27 to 30 of the Guidance set out the interpretation of the purpose of material uncertainty disclosure in the Guidance and in this Supplement.

53. This Supplement further adopts the interpretation that central bank liquidity insurance is a normal funding source for a bank and should not be regarded as being outside the normal course of business[49] or as being provided on other than normal terms for a bank. If access to those facilities is judged necessary to maintain the going concern status of the bank, then as long as there is a high level of confidence that those facilities will be accessible by the bank to a sufficient extent and over a sufficient time period to enable them to withstand the anticipated liquidity shock, the board should be able to conclude that the bank will remain a going concern for the foreseeable future.

54. Given that the overarching conditions of access to these facilities include that the bank must be judged to be solvent and viable by the Bank of England, when it lends under the facility, that the bank must provide sufficient collateral and that there must be a credible path to a point where access is no longer required, these are critical matters which will need to be considered in order to conclude that the bank will remain a going concern for the foreseeable future. There may be other conditions that have to be met too.

Assessing whether there is a material uncertainty

55. As explained above, the Bank of England aims to provide adequate liquidity insurance facilities through published support operations for the market as a whole that are responsive to system-wide shocks. The Bank of England may also provide support operations outside the published frameworks (ELA). Where a bank envisages a need to avail itself of such liquidity insurance facilities, the board should have a high level of confidence that, if needed:
    (a) those facilities will be accessible by the bank to a sufficient extent and over a sufficient time period to enable them to conclude that the entity will remain a going concern for the foreseeable future; and

[49] For a discussion of what is within or outside the normal course of business, see the Guidance: paragraphs 12 and 13 of Section 2 and paragraphs 23 to 25 of Appendix I.

(b) there is a credible path to repayment without resorting to action outside the normal course of business to realise its assets or discharge its liabilities.

56. If they are able to draw those conclusions, they should be able to conclude that there is no material uncertainty that is required to be disclosed by the bank. As for other companies, what constitutes action outside the normal course of business to realise a bank's assets or discharge its liabilities is a matter of judgment and should be considered in the context of the bank's financial flexibility and contingency planning, including its recovery plan.

57. These judgments are for the board alone insofar as they relate to the board's reporting responsibilities. However, there should be close dialogue with the Bank of England, the FSA (or in future the PRA) and the auditor in these circumstances. The Code of Practice for auditors and supervisors signals the importance of those channels of communication between auditors and supervisors being familiar and effective in both normal and troubled times.

58. The approach to the issue being addressed by the bank should take appropriate account of the likely escalation of supervisory intervention under the Proactive Intervention Framework in response to the issue, that ultimately would result in the referral of the entity into the SRR if it is considered that the bank is failing (or is likely to fail) to satisfy its 'threshold conditions' and it is not reasonably likely that alternative action will be taken that would enable it to meet those conditions. The board should seek to understand the status of escalation, the factors giving rise to this and the actions being taken to address them. Whilst these matters may not be definitive in determining whether there is a material uncertainty, they should be taken into consideration.

59. Where access to the Bank of England's liquidity facilities and/or to ELA is envisaged, the directors and auditors should seek to understand how the Bank of England would assess the solvency and viability of the bank and the credibility of the bank's plans to reach a point where access is no longer required. Without a sufficient understanding of this, the board may be unable to obtain a high level of confidence that, if needed, the facilities would be available to the bank.

60. If the board is unable to conclude that there is no material uncertainty that is required to be disclosed (or if the auditors are unable to concur), the directors should seek to understand whether the regulator believes that the entity should be referred into the SRR and, if not, why not.

61. If the directors remain unable to conclude that there is not a material uncertainty (or if the auditors are unable to concur), the directors may conclude that material uncertainty disclosures are required and/or the auditors may conclude that an emphasis of matter or qualified opinion is required.

62. However, in these circumstances, either of these disclosures may be expected to result in a run on the bank. As a result, the mere expectation of such disclosure may lead to the conclusion that the proposed disclosure would be sufficient grounds to trigger the bank's entry into the SRR and the circumstances should be discussed with the Bank of England and the prudential regulator. The directors and auditors should also consider whether there are any other reasons why public disclosure of the bank's actual or potential need to avail itself of liquidity insurance facilities should be made and, if so, the implications in this context.

Reporting and other consequences when a material uncertainty exists

63. The directors and auditors are responsible for making their own judgments about the future solvency and viability of the bank and cannot simply defer to the judgment of the Bank of England or Ministers. The consequence is that it is possible that the directors or auditors may be unable to obtain the

requisite level of assurance to conclude that there is not a material uncertainty even though the Bank of England or the prudential regulator may be able to conclude that the entity meets or would meet the conditions for access to the facilities.

64. Whilst this situation will remain a possibility, it is highly desirable that close dialogue between the various players should explore whether there are other sources of assurance that would enable a consensus judgment to be reached because that may avoid the need for the bank's entry into the SRR, when this would not be necessary if the board and auditors were able to obtain the requisite level of assurance.

65. Where a bank is, or envisages that it may be, reliant on Government or Bank of England support but the Bank of England is, or would be, unable to conclude that the entity is both solvent and viable, it seems likely that entry into the SRR will be triggered, either on the facts or because the directors or auditors of the bank conclude that disclosure is necessary and the expectation of that disclosure is the trigger. In practice, subject to early public disclosure of the use of resolution powers or of other actions being taken of the sort described in paragraph 41, disclosure of a material uncertainty by the directors or auditors may then become unnecessary or may be made in circumstances where the regulatory tools deployed to address the cause of entry into the SRR will protect the bank from the normal consequences of such disclosure.

Reporting

66. The general reporting responsibilities for a company described in the Guidance apply equally in the case of a bank.

67. Both the report of the Enhanced Disclosure Task Force and the BBA Code are useful reference sources to assist the board in assessing the effectiveness of its disclosures relevant to going concern – both those in the financial statements and in narrative and other financial reports. Each of these emphasises the importance of explaining the business model to provide context for the business and risk disclosures. Both contain a number of general principles for good disclosure and these have a degree of overlap.

68. The BBA Code sets out a number of key principles for disclosure and a protocol for the industry to work together in ensuring that disclosures are implemented in a manner which facilitates cross industry comparison.

69. The report of the Enhanced Disclosure Task Force specifically deals with enhancing risk disclosures by banks. It includes seven fundamental principles for enhanced disclosure, which also includes a cross-industry comparison principle. In addition, it provides an extensive analysis of current risk disclosure practices and makes thirty two recommendations for enhanced disclosures. Four of these are of a general nature and the remainder are categorised across seven broad risk areas, which the report considers to be the major categories of risk for banks:
    (a) Risk governance (and risk culture) and risk management strategies and the business model;
    (b) Capital adequacy and risk-weighted assets;
    (c) Liquidity;
    (d) Funding;
    (e) Market risk;
    (f) Credit risk; and
    (g) Other risks (including non-financial risks such as operational risk, reputational risk, fraud risk, legal risk and regulatory risk).

70. The general recommendations address the need to provide risk information in one place (or a navigation aid), to define terminology and measures, to describe and discuss top and emerging risks and to outline plans to meet new key regulatory ratios as their definitions are finalised.

71. In relation to top and emerging risks, the discussion suggests both that their nature is such that they are candidates for consideration as 'principal risks' (in terms of the business review disclosures) and that it may also be pertinent to consider whether they are significant solvency and liquidity risks:

> *"A top risk may be defined as 'a current, emerged risk which has, across a risk category, business area or geographical area, the potential to have a material impact on the financial results, reputation or sustainability or the business and which may crystallise within a short, perhaps one year, time horizon'. An emerging risk may be defined as 'one which has large uncertain outcomes which may become certain in the longer term (perhaps beyond one year) and which could have a material effect on the business strategy if it were to occur'."*

72. Each of the identified broad risk areas clearly has the potential to give rise to 'top and emerging' risks and there is much detail in the report that helps understand current disclosure practice and enhanced disclosures that may assist in meeting user needs in these areas.

73. The EDTF report provides guidance on levels of disclosure that could be made about matters relevant to the going concern assessment, such as: the risk management organisation processes and functions (recommendation 5); the risk culture (recommendation 6); key risks in the business model and the tolerance of risk and its management in the context of the business model (recommendation 7); stress testing (recommendation 8); regulatory capital management (and the role of risk weighted assets in that process) (recommendations 12 and 17); liquidity management (recommendation 18); Funding strategy (recommendation 21); and the management and governance of other risks (recommendation 31).

74. It also provides guidance on quantitative and qualitative disclosures that could be made about particular risks that may be relevant to the going concern assessment such as regulatory capital (recommendations 9 to 11), risk weighted assets (recommendations 13 to 16); funding risks and encumbrance analysis (recommendations 19 and 20); market risks (recommendations 22 to 25); credit risks (recommendations 26 to 30); and other risks (recommendation 32).

75. This general review of good and enhanced practice for risk disclosure should provide a strong base and an appropriate context within which to build the focus on significant solvency and liquidity risks that will:
    (a) Enable the board's rationale for its conclusion as to whether the bank is a going concern to be set in the context of its explanation of the business model, strategy and principal risks, with links to key quantitative and qualitative disclosures about those risks;
    (b) Enable the annual report to set out the board's conclusions about the robustness of the bank's going concern assessment process and its outcome including the going concern disclosures, in the context of the general disclosures about the bank's risk management and risk governance;
    (c) Enable the annual report to illustrate the effectiveness of the going concern assessment process by cross-referring to the key elements of disclosure about the risk management and risk governance processes that the board reviewed (including any advice it obtained from the audit or risk committee), the top and emerging risks that it reviewed as significant solvency and liquidity risks and, if appropriate, how they were addressed.

76. Boards should also consider how best to integrate the significant solvency and liquidity risk disclosures with other risk disclosures.

Glossary of Abbreviated Terms

BBA	British Bankers' Association
BIS	Department of Business, Innovation and Skills
Code	UK Corporate Governance Code, published by the FRC in September 2012
EBA	European Banking Authority
EDTF	Enhanced Disclosure Task Force, established by the Financial Stability Board
ELA	Emergency Liquidity Assistance
FRC	Financial Reporting Council
FRS	Financial Reporting Standard
FRSSE	Financial Reporting Standard for Smaller Entities
FSA	Financial Services Authority
FSB	Financial Stability Board
Guidance	The [Provisional] Guidance on Going Concern, January 2013
IAASB	International Auditing and Assurance Standards Board
IASB	International Accounting Standards Board
ICB	Independent Commission on Banking
IFRS	International Financial Reporting Standards
ISA	International Standard on Auditing
Panel	Sharman Panel of Inquiry into Going Concern and Liquidity Risks
PRA	Prudential Regulatory Authority
SRR	Special Resolution Regime for banks introduced under the Banking Act 2009
UK GAAP	UK Generally Accepted Accounting Practice
UKLA	UK Listing Authority – The FSA acting as the competent authority under Part VI of the Financial Services and Markets Act 2000

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Section 4 – Proposed Changes to the Auditing Standards

Contents

EXTRACT FROM INTERNATIONAL STANDARD ON AUDITING (UK AND IRELAND) 260 (REVISED ~~OCTOBER 2012~~MONTH 2013)

COMMUNICATION WITH THOSE CHARGED WITH GOVERNANCE

(Effective for audits of financial statements for periods commencing on or after ~~1 October 2012~~Insert date)

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Paragraph

International Standard on Auditing (UK and Ireland) (ISA (UK and Ireland)) 260, "Communication with Those Charged with Governance" should be read in conjunction with ISA (UK and Ireland) 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing (UK and Ireland)."

Planned Scope and Timing of the Audit

15. The auditor shall communicate with those charged with governance an overview of the planned scope and timing of the audit. (Ref: Para. A11-A15)

Significant Findings from the Audit

16. The auditor shall communicate with those charged with governance: (Ref: Para. A16)

    (a) The auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures. When applicable, the auditor shall explain to those charged with governance why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity; (Ref: Para. A17)

    (b) Significant difficulties, if any, encountered during the audit; (Ref: Para. A18)

    (c) Unless all of those charged with governance are involved in managing the entity:

        (i) Significant matters, if any, arising from the audit that were discussed, or subject to correspondence with management; and (Ref: Para. A19)

        (ii) Written representations the auditor is requesting; and

    (d) Other matters, if any, arising from the audit that, in the auditor's professional judgment, are significant to the oversight of the financial reporting process. (Ref: Para. A20)

Entities that Report on Application of the UK Corporate Governance Code

16-1. In the case of entities that are required[1c], and those that choose voluntarily, to report on how they have applied the UK Corporate Governance Code, or to explain why they have not, the auditor shall communicate to the audit committee the information that the auditor believes will be relevant to: (Ref: Para. A20-1)

- The board (in the context of fulfilling its responsibilities under Code provisions C.1.1, C.1.3 and C.2.1) and, where applicable, the audit committee (in the context of fulfilling its responsibilities under Code provision C.3.4); and

- The audit committee (in the context of fulfilling its responsibilities under Code provision C.3.2) in order to understand the rationale and the supporting evidence the auditor has relied on when making significant professional judgments in the course of the audit and in reaching an opinion on the financial statements.

[1c] In the UK, these include companies with a Premium listing of equity shares regardless of whether they are incorporated in the UK or elsewhere. In Ireland, these include Irish incorporated companies with a primary or secondary listing of equity shares on the Irish Stock Exchange.

If not already covered by communications under paragraphs 15 and 16 above~~,~~ and paragraph 23 of ISA (UK and Ireland) 570, “Going Concern”, this information shall include the auditor’s views: (Ref: Para. A20-2 – A20-7)

(a) About business risks relevant to financial reporting objectives, the application of materiality and the implications of their judgments in relation to these for the overall audit strategy, the audit plan and the evaluation of misstatements identified;

(b) On the significant accounting policies (both individually and in aggregate);

(c) On management’s valuations of the entity’s material assets and liabilities and the related disclosures provided by management;

(d) Without expressing an opinion on the effectiveness of the entity’s system of internal control as a whole, and based solely on the audit procedures performed in the audit of the financial statements, about:

(i) The effectiveness of the entity’s system of internal control relevant to risks that may affect financial reporting; and

(ii) Other risks arising from the entity’s business model and the effectiveness of related internal controls to the extent, if any, the auditor has obtained an understanding of these matters; ~~and~~

~~(e~~ (e) About the robustness of the directors’ going concern assessment and its outcome, including the related disclosures in the annual report and accounts; and

(f) On any other matters identified in the course of the audit that the auditor believes will be relevant to the board or the audit committee in the context of fulfilling their responsibilities referred to above.

The auditor shall include with this communication sufficient explanation to enable the audit committee to understand the context within which the auditor’s views relating to the matters in paragraph (d) above are expressed, including the extent to which the auditor has developed an understanding of these matters in the course of the audit and, if not already communicated to the audit committee, that the audit included consideration of internal control relevant to the preparation of the financial statements only in order to design audit procedures that are appropriate in the circumstances, and not for the purpose of expressing an opinion on the effectiveness of internal control.

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Application and Other Explanatory Material

Other Significant Matters Relevant to the Financial Reporting Process (Ref: Para. 16(d))

A20. Other significant matters arising from the audit that are directly relevant to those charged with governance in overseeing the financial reporting process may include such matters as material misstatements of fact or material inconsistencies in information accompanying the audited financial statements that have been corrected.

Entities that Report on Application of the UK Corporate Governance Code (Ref: Para. 16-1)

A20-1. Under the UK Corporate Governance Code, the responsibilities of the directors under Code provision C.1.1 include making a statement that they consider the annual report and accounts taken as a whole is fair, balanced and understandable and provides the information necessary for shareholders to assess the entity's performance, business model and strategy. The responsibilities of the audit committee under Code provision C.3.4 include, where requested by the board, providing advice in relation to that statement[7a]. The responsibilities of the board under Code provision C.2.1 include conducting, at least annually, a review of the effectiveness of the company's risk management and internal control systems[7b]. The responsibilities of the audit committee under Code provision C.3.2 include: monitoring the integrity of the financial statements of the entity and any formal announcements relating to the entity's financial performance, reviewing significant financial reporting judgments contained in them; reviewing the entity's internal financial controls and, unless expressly addressed by a separate board risk committee composed of independent directors or by the board itself, the entity's internal control and risk management systems[7c]; assessing the effectiveness of the audit process; and reporting to the board on how it has discharged its responsibilities. The supporting Guidance on Audit Committees indicates that the report to the board should include, inter alia[7d]:

- The significant issues that the audit committee considered in relation to the financial statements and how these issues were addressed; and

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[7a] Responsibility for ensuring the annual report is fair, balanced and understandable rests with the board as a whole. The board may ask the audit committee to provide advice on this.

[7b] In addition, FSA Rule DTR 7.2.5 R requires companies to describe the main features of the internal control and risk management systems in relation to the financial reporting process.

[7c] The FRC issues guidance for directors on their responsibilities with regard to internal control under the UK Corporate Governance Code (generally referred to as 'The Turnbull guidance'). The guidance indicates that the board takes responsibility for the disclosures on internal control and that the role of board committees in the review process is for the board to decide. The guidance also indicates the nature of the information the board may include in its narrative statement of how the company has applied Code Principle C.2.1.

[7d] The Guidance on Audit Committees also sets out other matters the audit committee should consider in relation to the annual audit cycle, including in relation to the audit plan and the auditor's findings.

- The basis for its advice, where requested by the board, that the annual report and accounts taken as a whole is fair, balanced and understandable and provides the information necessary for shareholders to assess the entity's performance, business model and strategy.

A20-2. In fulfilling these responsibilities, the audit committee and the board will be assisted by an understanding of:

(a) Issues that involve significant judgment; and

(b) Other matters communicated to them by the auditor relevant to those responsibilities.

This will include an understanding of the rationale and supporting evidence for the auditor's significant professional judgments made in the course of the audit and in reaching the opinion on the financial statements, and of other matters communicated to the audit committee by the auditor in accordance with the requirements of paragraph 16-1, including relevant information communicated in accordance with the requirements of paragraphs 15 and 16. The auditor's communications include information regarding separate components of a group where relevant. In fulfilling its responsibilities set out above, the board will be assisted by the report from the audit committee on how the audit committee has discharged its responsibilities.

A20-3. The audit procedures that the auditor designs as part of the audit of the financial statements are not designed for the purpose of expressing an opinion on the effectiveness of the entity's system of internal control as a whole and accordingly the auditor does not express such an opinion on the basis of those procedures. However, communication of the auditor's views about the effectiveness of elements of the entity's system of internal control, based on the audit procedures performed in the audit of the financial statements, may help the audit committee and the board fulfil their respective responsibilities with respect to the entity's internal control and risk management systems.

A20-4. The auditor's understanding of the entity includes the entity's objectives and strategies and those related business risks that may result in risks of material misstatement, obtained in compliance with ISA (UK and Ireland) 315[7e], and may also include other risks arising from the entity's business model that are relevant to an understanding of that model and the entity's strategy. To the extent that the auditor has obtained an understanding of such risks and the effectiveness of the entity's system of internal control in addressing them, communicating its views on those matters may be helpful to the audit committee and the board in their evaluation of whether the annual report is fair, balanced and understandable and provides the information necessary for users to assess the entity's performance, business model and strategy. However, the auditor is not required to design and perform audit procedures expressly for the purpose of forming views about the effectiveness of the entity's internal control in addressing such risks. Accordingly, to the extent

[7e] ISA (UK and Ireland) 315, paragraph 11(d)

applicable, the auditor may communicate that they have not obtained an understanding of, and therefore are not able to express views about, such risks and related aspects of the entity's internal control.

A20-5. The auditor's communication of views about the effectiveness of the entity's internal control may include, or refer to, the communication of significant deficiencies in internal control, if any, that is required by ISA (UK and Ireland) 265. However, views about effectiveness can go beyond just identifying such deficiencies. For example they may include views about such matters as the entity's strategies for identifying and responding quickly to significant new financial or operational risks; the quality of the reports that the board receives to provide them with information about risks and the operation of internal control; or how the entity's systems compare in general terms with those of other relevant entities of which the auditor has knowledge, such as the impact on internal control effectiveness that may result from different approaches to maintaining an appropriate control environment. The auditor's communications include its views relating to separate components of a group where relevant.

A20-6. Provision C.1.3 of the UK Corporate Governance Code requires that a statement is made by the directors that the business is a going concern, together with supporting assumptions or qualifications as necessary. An equivalent requirement is included in the Listing Rules of the UK Listing Authority and the Listing Rules of the Irish Stock Exchange, which also specify that the statement is prepared in accordance with "[Going Concern: Guidance for Directors of UK Companies 2012]" published by the FRC. This means that listed companies that are subject to those particular rules cannot opt out of making the disclosure under the 'comply or explain model' for reporting on compliance with the UK Corporate Governance Code. "[Going Concern: Guidance for Directors of UK Companies 2012]" is intended to assist directors in applying this part of the UK Corporate Governance Code and the relevant requirements of the Listing Rules. The guidance states that the annual report:

- Confirms that the directors believe that a robust assessment of going concern has been undertaken; and
- Illustrates the effectiveness of the assessment process by commenting on or cross referring to information on the material risks to going concern which have been considered.

Where the going concern assessment is undertaken by the audit committee, these disclosures may be given in the section of the annual report that deals with the work of the audit committee[7f].

A20-7. "[Guidance on Going Concern 2013 and the related Supplement for Banks]" provides guidance to assist directors in making their assessment of going concern and its outcome, including the related disclosures in the annual report

[7f] Paragraph 5.3 of the FRC's "Guidance on Audit Committees [September 2012]" states that the [audit] committee will need to exercise judgement in deciding which of the issues it considered in relation to the financial statements are significant [and should be included in the description of its work], but should include at least those matters that have informed the board's assessment of whether the company is a going concern.

and accounts. The board of directors may ask the audit committee and/or the risk committee to assist with this assessment. The directors may also be assisted in making their assessment by an understanding of the auditor’s views on the robustness of the directors’ going concern assessment and its outcome, including the related disclosures in the annual report and accounts.

INTERNATIONAL STANDARD ON AUDITING (UK AND IRELAND) 570 (REVISED MONTH 2013)

GOING CONCERN

(Effective for audits of financial statements for periods ending on or after ~~15 December 2010~~Insert date)

CONTENTS

International Standard on Auditing (UK and Ireland) (ISA (UK and Ireland)) 570, “Going Concern” should be read in conjunction with ISA (UK and Ireland) 200, “Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing (UK and Ireland).”

Audit Conclusions and Reporting

17. Based on the audit evidence obtained, the auditor shall conclude whether, in the auditor's judgment, a material uncertainty exists related to events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern. A material uncertainty exists when the magnitude of its potential impact and likelihood of occurrence is such that, in the auditor's judgment, appropriate disclosure of the nature and implications of the uncertainty is necessary for: (Ref: Para. A19 – A19-2)

(a) In the case of a fair presentation financial reporting framework, the fair presentation of the financial statements, or

(b) In the case of a compliance framework, the financial statements not to be misleading.

17-1. If the period to which those charged with governance have paid particular attention in assessing going concern is less than one year from the date of approval of the financial statements, and those charged with governance have not disclosed that fact, the auditor shall do so within the auditor's report[4b]. (Ref: Para A19-1)

17-2. In the case of entities that are required[4c], and those that choose voluntarily, to report on how they have applied the UK Corporate Governance Code, or to explain why they have not, the auditor shall read and consider in light of the knowledge the auditor has acquired during the audit, including that acquired in the evaluation of management's[1a] assessment of the entity's ability to continue as a going concern:

(a) The director's going concern statement; and

(b) The disclosures, in the section of the annual report that addresses the work of the audit committee, about the directors' assessment of going concern.

The auditor shall determine whether the auditor has anything to add or to draw attention to in the auditor's report on the financial statements in relation to these disclosures, and shall report in accordance with the requirements of ISA (IUK and Ireland) 700[4d].

17-3. Matters the auditor considers when determining whether there is anything to add or to emphasise in the auditor's report on the financial statements shall include, based on the knowledge the auditor has acquired during the audit, including that acquired in the evaluation of management's[1a] assessment of the entity's ability to continue as a going concern, whether:

[4b] If the non-disclosure of the fact in the financial statements is a departure from the requirements of the applicable financial reporting framework, the auditor would give a qualified opinion ("except for").

[4c] In the UK, these include companies with a Premium listing of equity shares regardless of whether they are incorporated in the UK or elsewhere. In Ireland, these include Irish incorporated companies with a primary or secondary listing of equity shares on the Irish Stock Exchange.

[4d] ISA (UK and Ireland) 700, "The Auditor's Report on Financial Statements", paragraph 22C.

- The auditor is aware of information that would indicate that the annual report and accounts taken as a whole are not fair balanced and understandable in relation to the going concern status of the entity; and
- Matters relating to the going concern status of the entity that the auditor communicated to the audit committee[4e] are not appropriately addressed in the section of the annual report that describes the work of the audit committee.

[4e] ISA (UK and Ireland) 260, "Communication with Those Charged with Governance", paragraph 16-1(e).

INTERNATIONAL STANDARD ON AUDITING (UK AND IRELAND) 700 (REVISED ~~OCTOBER 2012~~ MONTH 2013)

THE AUDITOR'S REPORT ON FINANCIAL STATEMENTS

(Effective for audits of financial statements for periods commencing on or after ~~1 October 2012~~Insert date)

CONTENTS

International Standard on Auditing (UK and Ireland) (ISA (UK and Ireland) 700, "The Auditor's Report on Financial Statements (Revised)" should be read in conjunction with ISA (UK and Ireland) 200, "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing (UK and Ireland)."

NOTE: The FRC has not ~~at this time~~ adopted ISA 700 "Forming an Opinion and Reporting on Financial Statements". The FRC has instead issued ISA (UK and Ireland) 700 "The Auditor's Report on Financial Statements (Revised ~~October 2012~~Insert Date)". The main effect of this is that the form of auditor's reports ~~may~~are not ~~be exactly~~ aligned with the ~~precise~~ format required by ISA 700 issued by the IAASB. However, ISA (UK and Ireland) 700 (Revised ~~October 2012~~Insert Date) has been drafted such that compliance with it will not preclude the auditor from being able to assert compliance with the ISAs issued by the IAASB.

Statement on the Directors' Going Concern Assessment Process

22C In the case of entities that are required[6], and those that choose voluntarily, to report on how they have applied the UK Corporate Governance Code or to explain why they have not, the auditor shall, having regard to the work performed in accordance with the requirement of paragraph 17-2 of ISA (UK and Ireland) 570, give a statement as to whether the auditor has anything to add or to draw attention to in relation to the disclosures made by the directors about the going concern assessment and its outcome, including the related disclosures in the annual report and accounts.

Appendix – Final recommendations of the Panel

Recommendation 1

The Panel recommends that the FRC should take a more systematic approach to learning lessons relevant to its functions when significant companies fail or suffer significant financial or economic distress but nonetheless survive. This might be achieved through a combination of approaches, including selective inquiries by the FRC (alone or, where practical and expedient to do so without undue delay, in conjunction with BIS, other regulatory authorities or others appointed by them to investigate or inquire into such circumstances). The FRC should consider whether it has adequate protocols with BIS and with other regulatory authorities to enable it to do so.

Recommendation 2

The Panel recommends that:

(a) The FRC should seek to engage with the IASB and the IAASB, ideally to agree a common international understanding of the purposes of the going concern assessment and financial statement disclosures about going concern, and of the related thresholds and descriptions of a going concern, in the international accounting and auditing standards;
(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; and
(c) The FRC should engage with the UKLA to seek to maintain the existing congruence of the Code and the related guidance for directors with Listing Rule 9.8.6 R (3), in light of these changes.

Recommendation 3

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.

Recommendation 4

The Panel recommends that, in taking forward its work on reporting under ECS, the FRC should move away from a model where disclosures about going concern risks are only highlighted when there are significant doubts about the entity's survival, to one which integrates going concern reporting with the ECS proposals through seeking 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;

and recommends that the FRC should amend the standards and guidance for directors and auditors accordingly when the ECS proposals have been finalised.

Recommendation 5

The Panel recommends that, as part of its work on auditor reporting arising from the ECS proposals, the FRC should:

(a) consider moving UK auditing standards towards inclusion of an explicit statement in the auditor's report as to whether the auditor has anything to add to or emphasise in relation to the disclosures made by the directors about the robustness of the process and its outcome, having considered the directors' going concern assessment process; and

(b) seek to encourage the IAASB to accommodate this approach in the ISAs.

Status of implementation of Recommendations not addressed in this Consultation document

Following FRC Reform, implementation of Panel Recommendation 1 is being facilitated through the Conduct Division's monitoring and carrying out Supervisory Inquiries. Panel Recommendations 2(a) and 5(b) are being implemented through seeking to influence the IASB[1] and IAASB. Panel Recommendation 2(c) is being implemented through dialogue with the UKLA which is expected to continue during the consultation period and in light of feedback from the consultation. The remaining Panel Recommendations are addressed in this consultation document.

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[1] At its meeting on 22-23 January 2013, the IFRS Interpretations Committee discussed possible changes to IAS 1 – the agenda paper can be found at:
http://www.ifrs.org/Meetings/MeetingDocs/Interpretations%20Committee/2013/January/031301%20AP%2003%20IAS%201%20disclosures%20about%20going%20concern.pdf

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