Going concern and liquidity risks: Lessons for companies and auditors

The ABI's Response to the FRC Sharman Inquiry

Introduction

1. The ABI is the voice of insurance, representing the general insurance, investment and long-term savings industry. It was formed in 1985 to represent the whole of the industry and today has over 300 members, accounting for some 90% of premiums in the UK.

2. The ABI is grateful for the opportunity to respond to the FRC's invitation to comment to the Sharman Inquiry on Going Concern. Our comments are given primarily from the perspective of our Members as institutional investors who, with assets under management of around £1.6 trillion, are major users of accounts and corporate financial reporting.

3. Our overall comments as well as detailed answers to the consultation questions are provided below. However, we should be pleased to discuss further any aspects of this subject in order to assist the Inquiry team in reaching its conclusions on matters relevant to this consultation.

General Comments

4. As a matter of context to the current Inquiry, we noted the publication in December 2010 of the ASB's paper on 'Financial Capital Management Disclosures'. That paper observed that "There are significant opportunities for improvement in reporting about capital. Reporting about capital as regards going concern and liquidity risk is clearly one dimension of this wider reporting agenda and it is perhaps an omission that the current Call for Evidence does not specifically reference the December 2010 paper.

5. As the ASB paper identified, investors approach capital issues in a diverse manner, as do companies. Some focus on historical invested capital, others on accounting capital and others on market capitalisation. Some view capital in pure equity capital terms whilst others include longer term debt. All these perspectives are valid and also potentially relevant to going concern assessment. For liquidity risk, a focus on cash flow and an understanding of how a company might manage its operations (including working capital requirements) and its acquisitions and disposals of fixed assets and other investments will be particularly critical.

6. The ASB paper also noted that many investors identified capital headroom as important, for example, against banking covenants and the availability of access to

additional capital, as useful information. Particularly at times when raising capital can be difficult or expensive, investors suggested that they want to know what cushion is available, and when and under what conditions additional capital might be required. Investors often have specific but different needs depending upon their valuation approach. For example, some investors base their valuations in part on forecast dividends and are interested in material constraints to the future growth in dividends that might be impacted by a shortage of capital.

7. Dividend paying capacity is, of course, particularly significant for understanding the viability of the company, perhaps most obviously in the case of regulated entities in the financial sector where there may be additional constraints imposed by regulators. However all companies are affected by requirements of company law as regards distributable reserves and capital maintenance. There is no requirement under law or accounting standards for financial statements to distinguish between realised profits and unrealised profits or between distributable profits and non-distributable profits. It may be thought helpful to users of financial statements if there is an indication of which reserves are distributable.

8. In summary, many aspects of financial reporting, and not just a narrow focus on concepts of capital, will therefore be relevant. Investors and creditors may indeed have varying time horizons over which they need to consider a company's viability. Short–term creditors' horizons are naturally limited to the period over which they reasonably expect to receive settlement of their claim against the entity. Shareholders. by contrast, will be interested in both long and short term perspectives and, for them, directors' opinions given over a twelve month period from the signing of the accounts is by no means a long-term perspective. Bondholders, will often have provided fixed-term financing to the entity covering many years, may well have perspectives that co-incide more closely with shareholders than short-term trade creditors.

9. For investors an understanding of the business model and its robustness will be crucial for allowing judgments to be made as regards long-term viability for the entity undertaking it. We note the significance that 'business model' is now assuming in the development of financial reporting. As yet it is premature to reach conclusions as to how far this is improving the quality of understanding in the minds of users of accounts.

10. Just as with financial reporting in the normal course, the information needs of investors and other users and the corporate governance and stewardship requirements of shareholders are relevant. In the case of the going concern the latter are of heightened significance. The Report and Accounts as a whole is important in providing the necessary information and management and auditors should be collectively responsible for signing off on numerical and narrative reporting to ensure it conveys the right picture.

Key Observations

11. We see merit in using corporate governance reporting as the specific repository of information regarding going concern but this should cross-reference relevant information conveyed elsewhere in the Report and Accounts. Investors in particular want to know the process the directors have gone through in reaching their judgment that the company was a going concern. The quality of directors' evaluation and disclosure of what directors have done to address any concerns is what is important. By contrast, additional boilerplate disclosures would be of no value.

12. In relation to liquidity risks as much as going concern *per se*, it is important to shareholders that the directors assess the appropriateness of the accounting policies on at least an annual basis. We think it could be helpful if there were a requirement for audit committees to state that they have made a thorough assessment of the accounting policies and believe they are appropriate to the company's circumstances.

13. We are aware of concerns in some quarters that assurance regarding going concern is part of an expectations gap. If so, we suggest that it might best be closed by considering the scope for auditors to give some positive attestation regarding the directors' opinion on which the appropriateness of the going concern basis of presentation of the accounts relies. Investors would wish, by contrast, to avoid the type of burden that compliance with the full panoply of US Sarbanes-Oxley requirements would lead to.

14. We indicate in our response to the detailed questions the importance of ensuring an appropriate element of prudence in judgments of going concern and liquidity risk. This to us appears to be the most significant matter that would benefit from greater coverage within the FRC's guidance to directors.

ANNEX

Questions for Consultation

Transparency of going concern and liquidity risk

1. What combination of information about:
• the robustness of a company's capital;
• the adequacy of that capital to withstand potential losses arising from future risks; and
• the company's ability to finance and develop its business model,
would best enable investors and other stakeholders to evaluate the going concern and liquidity risks that a company is exposed to? How effectively do current disclosures provide this information?

Once capital is committed to a business what assumes importance is the viability of the business and its ability to generate cash together with the ability of the company to meet its financing needs according to the maturity schedule of its existing borrowings, if any. Investors and creditors therefore need to have a good understanding of the entity's business model and of the likelihood that others, too, will have confidence in it. This in turn is the best guarantee of the company's ability to continue as a going concern. The quality of narrative reporting is particularly important here. Improvements to narrative reporting as a whole, focused in the UK on the Business Review, offer the prospect of enhanced understanding for investors.

Problems relating to cash flow are generally the reasons why companies fail. Headroom against banking and other loan covenants is of evident relevance. Reliance on short term debt funding and consequent refinancing risks will be of particular significance. Viability can change quickly when there is a downturn in both the robustness of the business and the financing environment. Boards may not be as aware as they should be of the comparative fragility of the position.

For investors in regulated financial companies their position as regards regulatory capital requirements is also important. Particularly in the case of banks, it is critical to the ability to continue their business activities. However there is at present inadequate disclosure of such information. Better disclosure would improve the information available to investors in making informed decisions but, perhaps most important, would enhance the ability of shareholders to exercise their stewardship responsibilities.

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

In addition to half-yearly presentation of financial results UK-listed companies are obliged under the EU Transparency Directive Quarterly to make quarterly trading updates. This provides regular opportunities for updating the market on information

relevant to going concern and liquidity risk. The obligation, which applies on a continuous basis, to disclose information that is materially price-sensitive means that unscheduled trading updates should be made if there is new information that might change judgments about the viability of the company. The regulatory requirements are as developed as they reasonably should be to meet the needs of investors.

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

There are no specific barriers that we are aware of. However, there may be room for doubt as to whether the obligation is fully complied with – perhaps because of the disinclination by management to recognise fully the implications of deterioration in trading or financing environment. There is also the inherent conflict in the interests of shareholders in receiving information if its dissemination might reduce confidence of the company's other stakeholders.

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

The primary focus of IFRSs on decision-usefulness and the information requirements of investors may have reduced their ability to be help shareholders and other users identify risks relating to going concern and liquidity. It is possible that the large quantities of disclosures required under IFRS may also make it difficult to identify key information relevant to going concern and liquidity risk. The lesser status that has been attached to the fundamental accounting concept of prudence may also have been detrimental in this regard. However, we emphasise that the going-concern assessment is not - or at least should not - be dependent on the specification of IFRS standards. As we indicate in our answer to Q 12, application of prudence might best be prescribed through the FRC's guidance.

Threats to going concern status inherently relate, at least in the early stages, to a low probability event. This is an inherent limitation of accounting, in that it requires point valuations of matters for which a probability distribution is a more faithful representation of the underlying reality. Indeed the adoption of a going concern basis of accounting even when there is a material uncertainty as to the entity's survivability over a 12 month timeframe only emphasises this limitation of what accounting can achieve. For this reason additional disclosures are of key importance for shareholders and other users who need to receive appropriate warning.

Company assessment of going concern and liquidity risk

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

• Which records and information are referred to in making this assessment?

• What type of model does the company use to develop scenarios to stress test the assumptions that have been made when making this assessment?
• What types of risks are included in the going concern assessment: financial, strategic, operational, other? How are these presented in the assessment?
• What is the role of the audit committee and risk management committee (where one exists) in this process and what inputs do they receive in order to carry out this role?
• What impact has undertaking the going concern assessment had on the planning and management of the company?
• How has the assessment of going concern and liquidity risks been incorporated into other aspects of company stewardship and reporting?
• How effective is this assessment in addressing the robustness and adequacy of a company's capital and its ability to continue financing and developing its business model? What, if any, improvements could be made?

These are essentially questions for preparers but for investors we would emphasise that the oversight role of the audit committee is of critical significance.

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

The required level of assurance and the quality of due diligence undertaken will be higher when in support of a capital raising and in support of a prospectus document. We consider it appropriate that a higher standard should apply where fresh capital is being raised from investors and where timing is under control of the issuer.

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

Institutional investors expect that this is done and, further, that in addition to any structured process involving board and relevant committees, the Chairman of the company and of relevant committees are advised should significant relevant changes in the company's circumstances take place.

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

Institutional investors recognise the challenges in anticipating the playing out of business cycles and they would maintain a healthy scepticism about the ability of company management and boards in this regard also. A company and its business might be viable over the course of such a cycle but, to survive, must be a going concern throughout. What directors need to recognise is that a component of prudence is required in reaching their judgments. It is at the most buoyant times of the economic and business cycle that risks of losing sight of prudence are greatest.

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

We consider the current approach appropriate and to be in the overall interests of companies and their shareholders, through meeting the information needs of investors while ensuring that confidence in the company is not unnecessarily brought into question. Nevertheless, we think that increased use of Emphasis of Matter paragraphs would be a means of alerting investors to material facts that would be relevant both to the appropriate valuation of the company and matters requiring careful attention. Again, we see the potential for existing work in the UK and internationally on improvements to reporting by auditors and/or audit committees to be of some assistance in respect of going concern assurance as well as more generally.

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

Matters of particular importance to investors are availability of bank finance, the existence of large pension deficits – particularly for companies with large legacy liabilities relative to the size of the current business, and delays in the date of the signing of the audit opinion. We also would highlight the inherent challenges of making reliable assumptions in times of continuing economic uncertainty as well as the risks arising from changes to regulatory environments, which may have liquidity consequences, directly and indirectly.

The auditor's approach to going concern and liquidity risk

11. How does the auditor approach the assessment of going concern and liquidity risk? To what extent does this involve the testing of the company's processes and what other work is carried out? Is there any specific reporting on the work done by the auditor on going concern and liquidity risk to Audit Committees? Does the assessment of going concern involve different processes in certain industry sectors? Are there different processes used where there is overseas reporting in addition to UK reporting?

Investors would expect auditors to base their approach on following the APB guidance.

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

12. Do you believe that amendments to the Guidance for Directors of UK Companies in respect of going concern and liquidity risk would be helpful? For example:
• Guidance for directors on disclosures does not specify the language to be used, whereas auditors use more standardised wording. Is this helpful?
• Is there a need for a clear boundary between the three types of company?
The guidance has been revised relatively recently and it may be premature to consider any extensive revision. However, one seeming omission is any reference to prudence. While the particular backdrop against which the guidance was revised in 2009 probably militated against emphasising this aspect we think the

circumstances are now appropriate for readdressing this and including appropriate reference to the need for prudence in assessing going concern and liquidity risk.

The existing guidance already makes reference to the use by the directors of sensitivity analysis in reaching their judgment. Further consideration might be given to where sensitivity disclosures about the principal risk and uncertainties should be given, as these can be particularly helpful to investors and others.

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

We have nothing specific to suggest at the present time.

ABI

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