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Dear Mr Leonard

FRC consultation on proposed changes to the directors' guidance on going concern

INTRODUCTION

1. Ernst & Young LLP welcomes the opportunity to comment on *Proposals to Revise the Guidance for Directors of Listed Companies, September 2008* ("the Guidance") issued by the Financial Reporting Council ("FRC").
2. We have a number of overall observations to make that we outline below before commenting on the FRC's specific questions.

OVERALL OBSERVATIONS

3. We believe the Guidance is particularly important in the current economic climate and therefore welcome the FRC's decision to review it. Although most of it has stood the test of time and remains useful and relevant, there are a number of areas where it could be improved, particularly in light of current market conditions. In this regard, we are mindful of the FRC's *Study: Going Concern and Liquidity Risk Disclosures* published on 27 November 2008 ("the Study") which suggests that there is room for substantial improvements in disclosures about liquidity risk. We therefore welcome the simultaneous publication by the FRC of additional guidance for directors entitled *An Update for Directors of Listed Companies: Going Concern and Liquidity Risk* ("the Supplemental Guidance").



4. Although the Guidance is specifically intended for directors, there is inevitably a connection with the reporting requirements placed on auditors by the International Standard on Auditing (UK and Ireland) 570 *Going Concern* ("ISA 570"). We therefore believe that it would be helpful for the FRC to make that linkage explicit, perhaps by way of an appendix addressing those audit responsibilities.
5. We believe it would be beneficial for directors to be reminded of the inter-connectedness between their duties (under this Guidance, accounting standards and FSA Listing Rules) and the requirement for the auditor to consider (under auditing standards) the appropriateness of management's use of the going concern assumption, and whether going concern disclosures in the financial statements give a true and fair view.
6. The Guidance should reinforce the importance for companies and their directors to make clear and transparent disclosures in the accounts and annual report around: estimation uncertainties; key assumptions; and critical judgments made in arriving at their conclusion on the use of the going concern assumption. This is crucial so that auditors are better able to make professional judgments about the appropriateness of management's use of the going concern assumption, and whether there are material uncertainties about the entity's ability to continue as a going concern, notwithstanding the uncertainties in the current economic climate. This might necessitate the increased use of "emphasis of matter" paragraphs. In other circumstances, where inadequate disclosures are made by the directors about material uncertainties, it may be necessary to "qualify" the auditor's report.
7. We believe that the tone and language of the Guidance could be more directive, particularly given the UK Listing Rules require that directors follow the Guidance when making going concern statements and particularly in light of the conclusions of the Study. We also believe it would be helpful for the Guidance to explain whether and how the Financial Reporting Review Panel might be examining going concern disclosures; both now and in the future.
8. Finally, we understand that the FRC plans to issue a revised version of the Guidance in mid 2009. We hope that the FRC will monitor closely the ongoing effectiveness of the Guidance and Supplemental Guidance, and encourage directors to apply it assiduously. We would also encourage the FRC to consider merging the Guidance and the Supplemental Guidance into one document. Certainly, the need for the Supplemental Guidance was more acute in light of current economic conditions. However, much of the guidance given applies not just to liquidity risk as we enter an economic downturn. It is applicable to other risks and potentially even in benign market conditions.

RESPONSES TO SPECIFIC QUESTIONS

Q1. In light of these developments, do you believe that there is a continuing need for separate guidance for directors about going concern?

Yes. Whilst accounting standards have addressed disclosures, no guidance is available on the process directors should follow to make their going concern assessment. We therefore believe that there remains a need for separate guidance.

However, guidance and procedures could be more helpful if they covered accounting and other developments in greater detail. For example:

- The link between the directors' consideration of going concern and the disclosure of credit, liquidity and market risks (required under IFRS 7/FRS 29).
- The requirements of s.417 of the Companies Act 2006 (Business Review)¹ and its potential link with the evaluation of a going concern.

Q2. Do you believe that the proposed amendments are sufficient and appropriate? If not, what alternative amendments do you believe need to be made and why?

We believe that most of the draft amendments are appropriate, but they may not be sufficient in number or detail, considering current market conditions and advances in corporate finance over the past fourteen years. Some of the new challenges and risks facing companies today can have a direct bearing on their status as going concerns, but some of these are not covered in the draft Guidance. Examples are shown below.

Key relationships

We believe the Guidance should emphasise the effects of key relationships on a going concern, consistent with the Business Review. In addition to the obvious banking and financing relationships, continued cover by credit insurers might also be critical. Similarly, the ongoing supply of services or goods from specific suppliers may be essential for a company to remain as a going concern.

It could be argued that these and similar issues fall within the "Financial Adaptability" section of the detailed procedures. However, we believe that guidance in these areas should include the requirement for directors to consider the financial stability of these key suppliers, and the availability of alternative sources if the need arises (including the speed with which such contingency plans could be implemented).

¹ Directors are required by UK Company Law to disclose in their Business Review the principal risks and uncertainties of their business, and information about persons with whom the company has contractual or other arrangements essential to the business of the company, which could be relevant to a company's going concern evaluation.

Treasury operations

It might also be helpful if more guidance is provided on the impact of complex financial instruments that companies may have entered into. This is because the range and complexity of products used in today's treasury operations, and the risks associated with their use, have advanced considerably since the Guidance was published in 1994. Errors of judgement and/or exceptional unforeseen circumstances in the application of these products by companies (or their creditors, suppliers or purchasers) could have significant consequences for a business which, in every other respect, may be regarded as a going concern.

Assessment periods and interim statements

Given that recent events have highlighted how quickly circumstances can change, we encourage the FRC to provide more guidance on how directors should review their previous work. Such procedures might include: updating forecasts in the light of recent trading activity; re-challenging availability of banking facilities (and the ability of banks to provide those facilities), and so on.

In addition, it would be useful if the FRC could cross-refer to the requirements of:

- IAS 34, which requires that the interim notes primarily include an explanation of the events and changes that are significant to an understanding of the changes in the financial position and performance of the entity since the last annual reporting date; and
- the Disclosure and Transparency Rules of the FSA, in respect of interim financial statements. In particular, a link should be made between the directors' consideration of the going concern status of the entity, and the requirement in the interim management report to describe "the principal risks and uncertainties for the remaining six months of the financial year".

Q3. Do you believe that any significant parts of the proposed guidance can be deleted as unnecessary? If so, which paragraphs can be removed and why?

We agree with the deletions suggested by the FRC and do not have any further suggestions of our own, other than our views on the amendment to paragraph 47 which we discuss below.

Q4. Do you believe that it continues to be appropriate to include standardised text within the proposed Guidance for Directors indicating how directors might explain their use of the going concern basis of accounting?

As the FRC notes, current practice has moved away from the provision of detailed guidance and we agree with that approach. We feel it is much better for directors to develop disclosures that reflect their specific knowledge and understanding of the position of their company. Accordingly, whilst we recognise that directors can find guidance helpful and we understand that the FRC may conclude that it is useful to continue to include

"basic" guidance, we think it is important that the essentially limited nature of this guidance is emphasised in the final document.

For this reason the additional "conclusion" in paragraph 47 concerns us. This is because any judgement the directors make about going concern will be somewhere on a continuum, and we are concerned that debates about whether they are in one category or the other may detract from the more important issue of ensuring that the directors' disclosures are appropriate. It may however be helpful to include a specific reminder of the requirements of IAS 1 where there are material uncertainties.

Q5. Do you believe that it continues to be appropriate for the guidance for directors to require directors to consider whether an additional disclosure should be given where they have not considered a period that extends to at least twelve months from the date of approval of the financial statements?

Yes. Whereas FRS 18 already requires a disclosure "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", IAS 1 (which most listed companies report under) only requires management to take into account all available information about the future, which is at least, but not limited to, twelve months from the end of the reporting period. Therefore it would be useful for the Guidance to require directors to consider this.

Such disclosure will also help to build consistency with ISA 570. The standard requires the auditor to make a disclosure in the audit report, if the period considered by the directors in making their going concern assessment is less than one year from the date of approval of the financial statements, and the directors have not disclosed that fact in the financial statements.

OTHER COMMENTS

We have two additional points to make.

First, we note that the proposed new Guidance requires the directors' statement on going concern to be included in the Business Review section of the Directors' Report, unless it impacts on the truth and fairness of the financial statements. However, the statement is not recognised in company law as a minimum requirement of the Business Review. Therefore, since accounting standards (e.g., IAS 1) already require disclosures to be made relating to going concern, we question whether it would be more sensible to combine going concern statements with these disclosures, or allow companies to publish them in a place of their choosing.

Secondly, recent large corporate failures, particularly in the banking sector, have highlighted a need for considerations on going concern to be made within the context of an overall understanding by directors of the sustainability of a company's business model, which would be communicated to shareholders, investors and other stakeholders and independently audited. Companies would also need to disclose details of their business model's sensitivities, including any impact on the model if any or all of the sensitivities were realised. We accept that this is

not a matter for the Guidance at this stage, but we recommend that the FRC, in conjunction with all stakeholders, debates this further.

CONCLUSION

We are grateful to the FRC for publishing this consultation and we hope you have found our comments helpful. If you would find it useful, colleagues in our firm are available to discuss further any of the points we have raised.

We wish you every success with the rest of the consultation process and encourage you to publish all non-confidential responses shortly after the closing date. We look forward to reading the results.

Yours sincerely



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