

**Hermes' Response to the FRC's Consultation on Guidance to Directors on  
Going Concern and Financial Reporting, September 2008**

**[Response to FRC by Monday 24 November 2008]**

**Introduction**

Hermes is one of the largest pension fund managers in the City of London and is the principal manager of the BT Pension Scheme. We also respond to consultations such as this one on behalf of many other clients, including Ireland's National Pension Reserve Fund, Denmark's PKA, Pensioenfonds PNO Media of the Netherlands, the UK's BBC Pension Fund and Canada's Public Sector Pension Investment Board (Only those clients which have expressly given their support to this response are listed here). Hermes has assets under advice of £60 billion (as at 31st July 2008).

Hermes takes a close interest in company reporting, in particular the annual report. We believe that annual reports are one of the most important vehicles through which companies can communicate with shareowners, and other stakeholders. As a result the reports are often the starting point of engagement with companies.

We firmly believe that the better the disclosure in the annual report, the better a window into the board's thinking and abilities to run the company in the long term interests of shareowners. Whilst the going concern statement in the annual report is a crucial disclosure, we believe that the guidance should focus on how the directors arrive at that disclosure and therefore the guidance is an opportunity to improve the overall narrative reporting by the company, in particular, the business review and the audit committee report.

**Summary**

We welcome the broad intention behind the proposals within the consultation paper. As a user of corporate reports, we welcome clear, honest and helpful disclosure from companies. The board's assessment of the going concern status of the company that it directs is an important one. We believe that the guidance to directors provided by the FRC on going concern assists the directors in considering the going concern statement but also in their wider responsibilities. We believe that the additional option available to directors to use in their statement of going concern should help to add clarity on the financial states of certain companies.

We suggest a few minor changes to the guidance which may better reflect the considerations that directors have to make, to take better account of how the directors should consider the economic environment in which they operate.

We also propose a few changes to emphasise the importance of the audit committee report and the business review as vehicles for full disclosure on some of the matters that pertain to whether the business is a going concern.

**Responses to specific questions**

**Question 1: In light of the significant changes to accounting standards that must be applied by directors of listed companies, do you believe that there is a continuing need for separate Guidance for Directors about Going Concern?**

Yes, we believe the guidance is a useful summary of the issues that directors should consider and it is particularly useful for those directors without a background in finance.

**Question 2: 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?**

**A)** We are surprised that the FRC has deleted the foreword. We believe that a foreword could be used to put the rest of the document into context in such a way that it encourages not only directors of listed companies but also of other companies as well as those people involved in producing or reading company accounts to read the guidance and to use it as a useful tool.

We understand that uncertainty increases significantly the further into the future that the board considers the likelihood of possible events. Nevertheless, we believe that some future events or liabilities may be relevant to the going concern discussion in the accounts. For example, an obligation to refinance significant amounts of debt 13 months after the approval of the accounts might be a legitimate matter to bring to investors' attention as part of the going concern discussion within some boards. With this point in mind, we suggest possible changes as follows:

- Paragraph 20 could be rephrased so that the beginning of the second sentence reads: "It is not possible to specify a minimum *or maximum* period..."
- Footnote 5 could also be re-written to highlight that the future period to which the directors have paid particular attention could be more than 12 months in particular circumstances. (We also note that paragraph 48 not only refers to detailed budgets but also the longer-term plans of the company as indicators that are relevant to the assessment of the going concern statement. We question whether these longer term factors are sufficiently highlighted in the guidance.)

**B)** We also suggest the following changes:

- Paragraph 22 could also refer to the audit committee's report. A disclosure from the committee that the particular matter or matters that might be considered relevant to the going concern statement had been fully debated by it would provide some useful reassurance to the readers of corporate reports.
- Paragraph 23 (last sentence): we believe that the last sentence should be re-written to read "Where the directors *have significant doubts that they are able or they* are unable to state that the going concern basis is appropriate, they should consider taking professional advice."
- The last sentence of Paragraph 30 should read "The *directors should* use sensitivity analysis..."
- Paragraph 39: Amend the last sentence: "The directors should use their understanding of the company, its resources and the state of the markets in which it operates to determine the key factors which could affect the company's future *and discuss these in the business review.*"

**C)** We also believe that the review of the guidance gives an opportunity to improve the disclosures under the business review.

For example, in paragraph 47: We believe that the new conclusion that the directors are able to reach is an important refinement of the guidance, reflecting additional disclosures required under IFRS. However, we believe that an honest explanation of the reasons for whichever conclusion the directors draw is important. In particular, a description of the thinking of directors when judging between whether factors do or do not cast doubt or significant doubt over the future of the business as a going concern will be of especial interest. We would therefore like to see a requirement in the guidance to require the board's thought processes in reaching the conclusion that they make. This should be required, as a minimum, for statements where there are doubts on the ability of the company to continue in operational existence. However, such statements would be very useful to all going concern statements. For instance, where, to an outside shareholder, it appears that there may be doubts as to the going concern status of a company but the going concern statement is unqualified it would be very useful for investors to see the directors' explanation of the board's thinking to reach that conclusion.

We also note that IFRS 7 requires an entity to describe how a company manages liquidity risk where it is material. Of almost equal importance to investors, is how directors reach the conclusion that this risk is not material when to an outsider it appears that it might be so. We would welcome the guidance to suggest that an explanation of the debate the directors had and why the board drew its conclusions on this type of issue would be very helpful regardless of the ultimate "going concern" conclusion that was drawn. By incorporating this concept, the guidance could improve the quality of the business review.

The foreword could be used to emphasise that good discussion of the board's thought processes are valuable to outside investors.

**D)** We also suggest some minor changes to paragraph 1.2 of the Appendix to reflect better the how the directors should take account of the performance of the company and the economic conditions in which it operates:

- We would suggest that the first bullet point should be re-written to read: "attainable gross profits are realistic and *take account of past and likely future performance...*"
- The third bullet point should read: "the patterns of debtor collections are realistic and *take account of current future debtor collections and projected future trends.*"
- The fifth bullet point should read: "working capital requirements are realistic and based on past performance, *taking account of likely future trends.*"

**Question 3: 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 do not believe that there is scope for significant deletion of the guidance.

**Question 4: 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?**

We believe that there is room for standardised text in the guidance but we believe that companies' debate of the issues elsewhere in the report (in particular within the business review and the audit committee report) should provide greater insight for users of the annual report.

**Question 5: 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, we believe that it is very important that directors consider this point. As we have also stated in our response, we believe that it is important that directors consider periods stretching beyond this timeframe.