

**KPMG LLP**  
1-2 Dorset Rise  
London, EC4Y 8EN  
United Kingdom

Tel +44 (0) 20 7694 8473  
Fax +44 (0) 20 7694 8086  
DX 38050 Blackfriars

Steven Leonard  
Financial Reporting Council  
5<sup>th</sup> Floor  
Aldwych House  
71-91 Aldwych  
LONDON  
WC2B 4HN

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Dear Mr Leonard

**Response to the FRC's exposure draft of proposed guidance on Going Concern and Liquidity Risk: Guidance for Directors of UK Companies**

We are writing in response to the invitation to comment on the FRC's exposure draft of proposed guidance on Going Concern and Liquidity Risk: Guidance for Directors of UK Companies.

Whilst we have made a number of comments in Appendices 1 to 3 to this letter, we wish to highlight the fact that overall we support the FRC proposal in bringing forward this suggested guidance as being the result of the review of the original 1994 guidance and reflecting the developments in *Going concern and liquidity risk* (the "Update") issued in late 2008. The 2008 document's approach to disclosure (and its examples) was an important advance, as was its proportionate approach to facility confirmations. We are pleased that this and other aspects of the Update are being carried forward. As to new issues addressed in the exposure draft, we very much agree that the look-forward period should be at least 12 months from the date of approval, whether the financial information in question is annual financial statements or interim financial statements. We also support the format in which the guidance is now cast.

We have set out in Appendix 1 to this letter the responses to the detailed technical questions that commentators have been asked specifically to consider. Appendix 2 contains details of the other comments of importance that we would wish to raise. Finally Appendix 3 contains all other comments including matters relating to drafting.

If you would like to discuss any aspect of our response, please contact me on 020 7694 8473.

Yours sincerely

Andrew Vials

## **Appendix 1**

### **Consultation questions**

#### ***Coverage of all UK companies***

**Question 1: Do you agree that the FRC should provide guidance on going concern relevant for directors of all companies? If so, do you believe that the Exposure Draft achieves this in a reasonably balanced way?**

Yes. We agree that the FRC should provide guidance on going concern for directors of all UK companies as there is clearly the need for such guidance on this subject. Subject to making various suggested changes outlined elsewhere in this letter, we believe that the Exposure Draft (as amended) will achieve this in a reasonably balanced way.

**Question 2: Do you agree with the principles as drafted? If not how would you amend them?**

Subject to making various suggested changes outlined elsewhere in this letter, we agree with the principles as included.

**Question 3: Do you agree with the three conclusions? If not, please explain what alternative you would suggest?**

As we stated in our response to the 2008 Consultation Paper, we were not convinced by the addition of a fourth category and hence we agree with the Guidance containing three conclusions only in the form specified. We also support the disclosure approach in the draft guidance which rightly recognises that for a “no material uncertainties” conclusion disclosure is still required with a range of different weights depending on the particular facts (e.g., Example 1 versus Example 2 in Appendix 1).

**Question 4: Do you agree that the directors should disclose when the period they have considered is less than twelve months from the date of approval of half-yearly and interim financial statements that give a true and fair view?**

Yes. In our view, the accounting standards (statement in UK GAAP) in relation to the preparation of half-yearly and interim financial statements require that the same approach is adopted in their preparation as for year end. Thus whatever is the look-forward period for full annual financial statements is also the look-forward period for interim financial statements. Since the full year period is signing plus (at least) 12 months, then for the interim it must be signing plus (at least) 12 months also. We should add, however, that this should be more than a disclosure requirement; the substance is that a 12 month period (at least) review period should be used.

**Question 5: Do you believe that it would be appropriate to replace the existing Guidance for directors with this document for periods ending on or after 31 December 2009? If not, what alternative application date would you suggest?**

We believe that it would be appropriate to replace the existing Guidance for directors with this new Guidance for accounting periods ending on or after 31 December 2009. Whilst the FRC may only be able to issue the final version of the revised Guidance in late 2009, the exposure draft was issued in May 2009 and therefore the fact that new Guidance may need to be applied should not be a surprise to directors assuming, as seems likely, that the overall content of the finalised Guidance is substantially the same as the draft. Moreover, the draft has very much a consolidating and evolutionary nature and thus does not represent a significant break with the past.

## Appendix 2

### Other matters

We have reviewed in detail the proposed guidance and have set out below the major matters arising (other than where detailed questions are being asked). Appendix 3 contains all other comments including matters relating to drafting.

#### ▪ **Interim financial statements that are intended to give a true and fair view**

We question whether it is appropriate or necessary, in paragraph 3 and elsewhere throughout the Guidance (including within the Principles), to refer to interim financial statements “that are intended to give a true and fair view.”

The vast majority of interim financial statements do not give a “true and fair view” as they are condensed rather than a full set of financial statements. This has been the long held view in the UK. The incongruent idea of true-and-fair interims was introduced by EU directives. In our view, we should be trying to confine or roll back rather than promote this incongruity that might otherwise lead to the idea that true and fair view means mere compliance with applicable standards.

The Transparency Directive was issued by the EU in December 2004 and came into force in the UK from 20 January 2007. It itself contains the requirement that those responsible for the preparation of interim financial statements must prepare them such that they give a true and fair view and need to include a responsibility statement confirming that fact.

It was implemented in the UK by the FSA including its requirements within the Disclosure Rules and Transparency Rules (DTR). DTR 4.2.10R (4) gives the directors an “escape” route from “true and fair view” in their responsibility statement by instead stating compliance with IAS 34 or, for UK GAAP preparers, the ASB Statement *Half-Yearly Financial Reports* as satisfying the requirement of DTR 4.2.10R (3); this is so as not to promote the idea of true and fair interims. We think that the FRC guidance should similarly eschew the idea of true and fair interims. For example, the words “intended to give a true and fair view” could be omitted from Principle 1, or the words “or when preparing interims” could be added after those words.

Removing the true and fair view from interims would also assist in scoping the guidance appropriately. Companies quoted on AIM or on PLUS Quoted are also required to prepare interim financial statements (referred to as “half-yearly report” in AIM Rule 18 and “interim results” in PLUS Rule 30). There is no specification that such interims must be true-and-fair (IAS 34 or the ASB Statement *Half-Yearly Financial Reports*), and most follow the recognition and measurement (but not disclosure) requirement of their applicable GAAP as well as the specific disclosure requirements set out in their applicable Rules. Only in very rare cases would interim financial statements for companies listed on AIM or PLUS Quoted be full enough to give a “true and fair view.”

Thus setting the scope of applicable interims as those giving a true and fair view would result in the vast majority of those companies quoted on AIM or PLUS Quoted being outside the guidance. Whilst the FRC may wish to set out differing requirements for these two different groups for interim financial statements we would struggle to understand why the Guidance (save for the specific guidance relating to the Listing Rules) should not be equally relevant to AIM and PLUS Quoted companies.

▪ **Extent of disclosure in interim financial statements**

Paragraphs 83 to 84 cover interims disclosure. At the interim stage the fact that the company's situation is unchanged, especially in those cases where there are material uncertainties leading to significant doubt about going concern, will be highly relevant in understanding an entity's position. Yet the draft guidance might be read as implying that if nothing has changed since the last annual financial statements then some short statement is all that is required to be given. And if there have been changes it might read as if a few words of update would suffice.

As going concern is so fundamental, in our view if Example 2 or Example 3 disclosures of Appendix 1 were appropriate at the previous year end, then the interim financial statements should give the complete picture rather than referring the reader back to the state of play six or some months ago set out in another document, together with a current statement of any changes. We believe that a fresh retelling of the complete, up-to-date story is far more important in these circumstances than many of the other disclosures in the interims.

▪ **Clarity over the 12 months look-forward period**

The exposure draft might be seen as sending mixed messages on the length of review period. Paragraph 30 is very clear on twelve months from sign-off or longer. We agree. On the other hand, Principle 3 and associated paragraphs read as if directors can freely choose less than twelve months, with paragraph 56 indicating that "it is likely ... will adopt a review period of not less than twelve months ..." but imposing no consequence of departure other than to disclose that fact. We appreciate that, in so doing, this part of the Guidance is re-telling the requirements of UK GAAP. However, this does not recognise that section 2 of the Guidance rightly goes further.

We also note that the 1994 Guidance required not solely disclosure of the fact of a short look-forward period, but also a justification. Might a way forward be to focus the disclosure on the justification to any exceptions to the position in paragraph 30 which, the Guidance could point out, would be rare?

▪ **Disclosures relating to going concern**

Paragraph 64 sets out that the FRSSE, UK GAAP and IAS 1 all require directors to disclose the existence and nature of the uncertainties where they have concluded that there are "material uncertainties that may cast significant doubt upon the entity's ability to continue as a going concern." We welcome this paragraph, and the following one, which will be helpful in setting the directors' expectations as to what all auditors will insist upon when they seek to apply, in all good faith, the requirements of auditing standards.

For completeness, we think it would be helpful to add here the remaining words of paragraph 32 (b) of ISA (UK and Ireland) 570 after "material uncertainties", viz: "and, therefore, that the company may therefore be unable to realise its assets and discharge its liabilities in the normal course of business." (Example 3 in Appendix 1 should be updated accordingly).

Paragraph 66 states that "in addition, for medium and large companies a number of UK GAAP and IFRS standards require specific disclosures to be made about liquidity risk and other risks." These may equally apply to small companies if their annual financial statements are not prepared under the FRSSE.

- **Appendix 1 Examples**

In examples 1 to 3 it is important that each note should deal with only auditable information, which may exclude certain factors likely to affect the company's future development set out in the Business Review which is being cross-referenced to from this note to the financial statements.

- **Appendix 2**

Financial adaptability – in the discussion on possible courses of remedial action it would be very helpful if the FRC gave a clear steer that there was a pretty high hurdle as regards evidence needed on planned actions which are outside the control of the company before moving the going concern issue from Appendix 1 Example 3 to Example 2 territory.

### Appendix 3

#### Other matters

- **FRSSE**

The draft guidance refers in paragraph 4 and elsewhere throughout the Guidance to the Financial Reporting Standard for Smaller Entities (FRSSE) as if it were separate from UK Generally Accepted Accounting Principles (UK GAAP). We do not believe it is appropriate to separate out the FRSSE in this way, since the FRSSE is part of a – sub-set of – UK GAAP. We would suggest the guidance should adopt a formulation that makes this clear; for example (in paragraph 4): “UK Generally Accepted Accounting Principles (UK GAAP), which includes the Financial Reporting Standard for Smaller Entities (FRSSE), and International Financial Reporting Standards (IFRS).”

- **UK GAAP**

In paragraph 4 UK GAAP is stated to be UK Generally Accepted Accounting **Principles**. In all the recent APB Bulletins on example audit reports, UK GAAP is stated as being UK Generally Accepted Accounting **Practices**.

- **IFRS**

As UK entities apply International Financial Reporting Standards as adopted by the EU rather than International Financial Reporting Standards as issued by the IASB, in paragraph 4 (the first use of this term in the Guidance) IFRS should be defined as being “International Financial Reporting Standards as adopted by the EU (IFRS).”

- **Smaller companies**

Paragraph 6 states that “smaller UK companies benefit from certain concessions in relation to the accounting standards to be applied and to the content of their financial statements filed at Companies House.” It would be more correct to phrase it as, “smaller UK companies **may** benefit from certain concessions ... .”

- **Group companies**

Paragraph 7 paints a simplistic picture of going concern assessments in group. There is normally a lot of interdependency. If, on the other hand, it is intending to deal with a subsidiary that would not taint the rest of the group, then we should agree that neither the group, nor the figures for that subsidiary for inclusion in the group financial statements, are prepared on a break-up basis but that other issues surrounding the group accounting for the subsidiary would arise. If this is the intended message, nevertheless it may be off-point to the real issues.

- **Difficult economic conditions**

The last bullet in paragraph 8 would be a good place to make/ re-emphasise the points that investors should not assume that a going concern basis means that the company will continue, nor that disclosures about going concern mean that it will not.

▪ **Precise use of ISA 570 (UK and Ireland) terms**

In paragraph 11 and elsewhere (paragraph 57) reference is made to the conclusions of “there are no material uncertainties that lead to significant doubt about the company’s ability to continue as a going concern” and “there are material uncertainties that lead to significant doubt about the company’s ability to continue as a going concern but the going concern basis remains appropriate.” ISA 570 (UK and Ireland) 570 paragraph 32 (b) has slightly different words. Therefore it may be sensible that the wording be updated to additionally reflect the ISA 570 (UK and Ireland) wording such that it refers to “material uncertainties **related to events or conditions which may cast that lead to** significant doubt about the company’s ability to continue as a going concern...” to ensure that the recommendations for the preparers of the financial statements and the requirements for the auditors are articulated in the same terms.

Similarly paragraph 19 states that if “auditors conclude that a material uncertainty exists which leads to significant doubt about the ability of the entity to continue as a going concern they are required to modify their report by including an emphasis of matter paragraph even if fully explained in the financial statements.” ISA 570 (UK and Ireland) 570 paragraph 30 has slightly different words. Therefore for the same reason of consistency it may be sensible that the wording here in paragraph 19 also reflects the ISA 570 (UK and Ireland) wording such that it refers to “auditors conclude that a material uncertainty exists **related to events or conditions that alone or in aggregate may cast which leads to** significant doubt on the ability of the entity to continue as a going concern they are required to modify their report by including an emphasis of matter paragraph even if fully explained in the financial statements.” Similar changes would then be needed to paragraph 81 (which is almost precisely the same as paragraph 19).

▪ **Review process**

As noted in the main text of our letter, we support the inclusion of paragraphs 12 and 13. We wonder, however, whether they might be better located in Section 2 (e.g., after paragraph 36).

▪ **Difficult market conditions**

On reflection, Principle 1 asks for a rigorous assessment even in benign times at a healthy company. “With appropriate rigour” might be better (gives a sense of proportion).

▪ **Use of the term financial statements**

The term “financial statements” is used widely in the draft Guidance. In most cases we wonder whether the use of the term financial statements means just annual financial statements or does it mean both annual and interim financial statements? It would be helpful to clarify.

▪ **Disclosures**

Paragraph 17 refers to “the FRSSE, UK GAAP and IFRS require explicit disclosure of the uncertainties that directors are aware of arising from their assessment of going concern that may cast significant doubt on the group’s or the company’s ability to continue as a going concern.” FRSSE 2.12, FRS 18.61 (a) and IAS 1.25 all refer to “**material** uncertainties.” We believe that the Guidance should include the term as included in these accounting standards. This would also ensure consistent terminology with the auditors’ requirements.

The final sentence of paragraph 17 that an unqualified conclusion (*by whom: the directors or the auditors?*) is presumed unless specific reference is made may be confusing. It might imply

for instance that no disclosure as set out in examples 1 and 2 in Appendix 1 are needed for the first category in the table in paragraph 20 which is contrary to what paragraph 20 is setting out.

- **Listing Rule requirement**

Paragraph 18 should refer to UK listed companies rather than just listed companies to reflect the precise nature of LR 9.8.6R.

- **Modified audit reports**

We believe that a clearer explanation of the nature of modified reports is required in order that directors are able to put the alternatives into context. Paragraphs 19, 81 and 82 explain that even if any material uncertainties are fully explained, auditors may need to modify their report by including an emphasis of matter paragraph; and that if the disclosures are inadequate the auditors are required to qualify their opinion. It would be helpful if the guidance more precisely followed the wording in ISAs (UK and Ireland) 570 and 700 and drew a clear distinction (as highlighted in paragraph 29 and explained in paragraph 30 of ISA (UK and Ireland) 700) between an emphasis of matter which does not affect the auditors' opinion and a qualification which does. Paragraph 75 could also be drafted to reflect the distinction between matters that affect the auditors' opinion and those that do not.

- **Summary table in paragraph 20**

We believe the guidance should make it clear that even where there are no material uncertainties some disclosure may nevertheless be required rather than just "may need to be made." We suggest that the summary table (row 1 column 2,) should emphasise that the extent of disclosure will vary depending on the nature and extent of the uncertainty.

- **Precise use of Listing Rules text**

In the table in paragraph 20 for the first category the requirement from the Listing Rules should be given fully (as used in the second category) by the addition of the words "together with supporting assumptions or qualifications as necessary."

- **Presumption over going concern**

Paragraph 22 refers to principles within the Companies Act 2006. However, this applies only if the financial statements are prepared under UK GAAP. As the Guidance should be covering IFRS financial statements as well the content of paragraph 23 of the IASB's *Framework for the Preparation and Presentation of Financial Statements* should also be referred to or alternatively paragraph 22 changed to instead being, "For example ...".

Paragraph 23 of the exposure draft refers to a company having no realistic alternative but to cease trading, but omits the possibility of management intending to cease trading, although this is correctly referred to in the accompanying box. Paragraph 57 again refers to circumstances in which there is no realistic alternative to liquidation, while omitting the possibility of management intent.

- **Group or own financial statements**

Paragraph 25 refers to the fact that the "directors of subsidiary companies of a group need to make their own assessment of the going concern basis of accounting and will take into account the specific facts and circumstances of the subsidiary company and any need for financial

support from the parent company or fellow subsidiaries.” For the avoidance of doubt we would suggest adding “when approving the financial statements of that subsidiary company” at the end of that sentence.

▪ **Forecasts and budgets**

In relation to paragraph 30 we think that “at least” is better wording than “up to”. The latter might be misread as meaning “less than or equal to”.

▪ **Procedures more relevant to medium and large companies**

In paragraph 31, insert “beyond formal budgets and forecasts” after “further periods”. It is often the case that the forecast runs for, say, 15 months from the sign-off date.

Paragraphs 33 and 34 cover output markets, which is fine so far as it goes. But there is nothing explicitly covering equivalent issues for inputs (e.g., security of supply). And there is nothing on the business model as a whole.

▪ **Borrowing requirements**

It is difficult to imagine that the procedures at paragraph 35 are not also relevant to smaller companies.

▪ **Sensitivity analysis**

Paragraph 42 states that “sensitivity analysis involves assessing the extent to which the going concern status of the company varies with changes in assumptions.” It is important to make it clear that such an assessment is only necessary to the extent that the changes are reasonably possible, except when additional stress testing is required under paragraph 44.

▪ **UK companies that use UK GAAP**

Paragraph 45 of the draft Guidance refers to condensed interim financial statements prepared in accordance with IAS 34. It might be helpful to refer to the ASB Statement *Half-Yearly Financial Reports* for UK GAAP preparers.

▪ **Use of the term interim financial statements vs half-yearly financial statements**

Generally the Guidance refers to interim financial statements. However, there are some instances of the use of the term “half-yearly financial statements” which in some cases is used next to the term “interim financial statements” (it is not clear to us why) and in some cases in place of “interim financial statements.” Although the terms may be interchangeable with the same meaning it would be (as far as possible) better to have a consistent term used throughout except where there is an (explained?) need (if any) to use a differing term.

▪ **Interim financial statements for small companies**

We assume that the paragraph 52 reference to smaller companies is to those within the Companies Act's small company regime. If so, it would be better to make this clearer as otherwise, say, some AIM or PLUS Quoted companies might think of themselves as small.

In addition this sentence is not factually correct given the scope (paragraph 2, first sentence) of the ASB Statement *Half-Yearly Financial Reports*.

- **FRSSE Disclosures**

Paragraph 58 states that the “FRSSE does not specify the nature of the disclosure requirements that should be made where directors of a smaller company identify a material uncertainty that leads to significant doubt about going concern.” This statement would appear contrary to paragraph 2.12 of the FRSSE which sets out in summary the disclosure requirements.

Paragraph 58 also states that the “directors of smaller companies will also need to consider whether **other** uncertainties [*other than going concern?*] need to be disclosed in order for the financial statements to give a true and fair view.” First, it is not clear whether this implies just smaller companies applying the FRSSE or all small companies (which it should be). Second, surely all sizes of company need to consider whether **other** uncertainties (if this means other than in respect of going concern matters) need to be disclosed in order for their financial statements to give a true and fair view.

- **Disclosures relating to going concern**

In the table in paragraph 66 references are made to the 2008 version of IFRS and UK GAAP 2007/8. More recent publications now exist being a 2009 version of IFRS and UK GAAP 2009/10.

In this table the existence of FRS 13 has been ignored at present. Whilst the number of entities within the scope of FRS 13 is limited (such as companies listed on PLUS Quoted, some Building Societies) it does have different requirements for disclosures relating to risks arising from financial instruments, including liquidity risk where it is material, and unlike FRS 29 does have requirements in respect of disclosure of undrawn borrowing facilities (paragraph 40 of FRS 13). Perhaps some reference needs to be made to these requirements.

- **Location of disclosures**

We agree that, as set out in paragraph 77, it is helpful if going concern and liquidity risk disclosures are brought together in a single note to the financial statements. However, it needs to be the case that cross references are given only to information included elsewhere in the annual report that is capable of being audited.

- **Auditors' reports**

In paragraph 81, “even if” should read “provided that”, we think.

- **Auditors' interim review reports**

For the avoidance of doubt, and to make this section self-contained, we recommend that paragraph 86 be expanded to mention specifically the requirements within paragraphs 56 and 59 of ISRE (UK and Ireland) 2410.

- **Appendix 1 Examples**

Appendix 1, Examples 4 and 5 are based on a smaller company “that has adopted the FRSSE.” Is whether or not the company has adopted the FRSSE relevant? For example would these examples be different if it was a small company that fully adopted (non FRS 26, non-FRSSE) UK GAAP?

Appendix 1, Example 4 includes the wording “costs are expected to reduce ... .” This should be redrafted to make it clear that it is the directors who expect costs to reduce.

In all of the examples we think that the “after making enquiries” is redundant disclosure. The matters enquired into are as stated above. “Accordingly”, would be better suited, and it would not suggest a mis-reading as to some of the material considerations or enquiries that are not disclosed.

▪ **Appendix 2**

Borrowing requirements – this section does not mention assessment of “headroom” specifically. We would have thought this was fairly critical.

Products, services and markets – in 5.3 no mention is being made of key suppliers.