TREASURY, RISK AND FINANCE PROFESSIONALS
ACT

The Association of Corporate Treasurers

Comments in response to

Exposure draft: Going Concern and Liquidity risk: Guidance for Directors of UK Companies

Financial Reporting Council, May 2009

August 2009

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The Association of Corporate Treasurers (ACT)

The ACT is a professional body for those working in corporate treasury, risk and corporate finance. Further information is provided at the back of these comments and on our website www.treasurers.org.

Contact details are also at the back of these comments.

We canvas the opinion of our members through, our monthly e-newsletter to members and others, *The Treasurer magazine*, topic-specific working groups and our Policy and Technical Committee.

General

The ACT welcomes the opportunity to comment on this matter.

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Response to the Exposure Draft

Overview

- The ACT thought that the FRC's move last year to issue the interim guidance on this subject was very helpful.
- We think that the draft Guidance is again very helpful and timely in the present economic conditions and for the future, whatever the shape of the recovery. The clear language and realistic approach to the position of directors considering the going concern question are welcome.

Response to questions

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 and yes. Guidance is important for directors of all firms in considering the basis for preparation of accounts.

In doing this the FRC is really filling in a gap in the publications of the setters of accounting standards, notably the IASB, that is only partly addressed in related company law and, for listed companies, securities market provisions.

Stakeholders in all companies will always, and especially in uncertain times, want have an idea of what directors took into account in determining a going concern assumption.

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

Yes.

Principle 2, however, may not be a principle but an indicator of the extent of the diligence required in following the principles. It is important to retain the idea, however it is categorised.

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

We agree with the substance of the three conclusions.

It would be more helpful if the wording of paragraph 11 conclusions were adjusted to be identical with the wording in para. 20. Small differences simply distract in a presentation. (See also comment on para. 57 below.)

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.

We think that the Principle 3 requirement that "Directors should consider all information about the future that they are aware of" is very important and we are concerned at the enormous concentration scattered through the Guidance on 12 months.

Among the information directors should consider will be what SEC guidance in another context has long called "known unknowns" – even if their resolution is some time into the future. Examples might be the expected availability of renewed or new

financial facilities or the uncertainty of renewal of operating licences[1]. Such issues should be included in directors' considerations.

We think that the tone of references to 12 months should adjusted to make 12 months seem less like the answer for all companies.

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?*

Yes. The existing guidance and the November 2008 Update are already relevant. We do not consider that this new Guidance should require significant additional workload for anyone involved in preparation of accounts. Accordingly the relatively short notice of the "application date" seems appropriate. It is not obvious that the Guidance should wait come into effect simultaneously with a change of the FSA's position, even for listed companies, as the new Guidance does not represent a slackening of the previous Guidance.

Other comments

Paragraphs 1 to 19 of the Exposure Draft

We think that the approach taken in this section is very useful. Much of it can be quoted directly in briefing directors rather than needing to be re-presented.

Paragraphs 1 to 3 of the Exposure Draft

The guidance is to help directors in carrying out their duty as a board to determine whether to adopt a going concern basis for financial statements. It would be good to see a reminder of that "duty" baldly stated perhaps as a new second sentence in para. 1: "Directors have a duty to determine the basis for financial statements."

That some directors are members of audit committees and that "finance teams" will play a part while secondary to the duty just referred to are still important. So following the proposed new second sentence with the existing second sentence with a new start thus: "This Guidance will *provide a framework …"* would then be appropriate. (The tentativeness embodied in "*is designed to provide"* is inappropriate here where the FRC is setting out to influence behaviour in important ways.)

Paragraph 11 of the Exposure Draft

While para. 7 touches on the possibility that a subsidiary may cease trading, that the company preparing the accounts may itself cease trading or be liquidated is not referred to until para 21. This seems very late, although the reluctance to be blunt about this is understood. "In the last case the company has no realistic alternative but to cease trading or go into liquidation" could usefully be added after the last bullet in para. 11.

See also answer to Question 3.

Paragraphs 12 and 13 of the Exposure Draft

[1] Of course, announcement of the future loss of an operating licence might immediately constitute a "material adverse change" which would act to stop drawings even under existing financings well before the date of the loss taking effect.

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We take particular interest in paragraphs 12 and 13. They are very appropriate.

1st of 2 comments)

We draw attention to the following from the August 2009 Inflation Report of the Bank of England (at page 14):

> "… some contacts have told the Bank's regional Agents that their auditors required them to secure refinancing before signing off their accounts, perhaps reflecting concerns over the future availability of finance. Indeed, some companies have paid a premium to refinance existing lending early (using so-called 'forward-start' agreements), according to reports from the major UK banks."

While it may be sensible for companies to lock-in facilities for longer periods ("fund early and fund long" is often a good policy), the Agents' comment suggests some companies may have an accounting rather than an economic primary motive in these cases and perhaps some auditors will benefit from the restatement of the FRC's guidance in paragraph 13.

2nd of 2 comments

Paras. 12 and 13 consider ("for example") the confirmation of facilities from banks – and in a very helpful way. Confirmation is not the end of the story however and other factors need to be taken into account.

It was demonstrated in 2008:

- A committed available line from an illiquid bank or insolvent bank may prove unavailable as was seen by companies with facilities from Icelandic banks or Lehman.
- Even if a company has own funds available, the expected liquidity of those funds during the period under consideration is important. Funds deposited with Lehman or Icelandic banks became unavailable and other institutions threatened to follow a similar path. Holdings of securities may become illiquid or immediately realisable only at material discount.

Of course, as referred to above even, a confirmed or contractual facility may not be available for drawing even if no breach of covenant has occurred – commonly in case of inability to repeat warranties or occurrence of a "material adverse change".

These are among the many factors directors need to take in to account in their deliberations.

Paragraph 20 of the Exposure Draft

"I.e. the company has no realistic alternative but to cease trading or go into liquidation" could usefully be added in to or footnoted from the bottom left box of the table.

Paragraph 25 of the Exposure Draft

While the wording says directors of subsidiaries should take account of the need for financial support, we suggest that this should be widened. First, subsidiaries need to take account not just of their need for but of the ability and willingness of parents to provide support. Second, subsidiaries may, in order to continue to be viable, need technical or other support of a parent or fellow subsidiaries. Directors of

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subsidiaries would benefit from inclusion to reference to these issues in the Guidance even though (or perhaps, in some cases, because) such reference may be inconvenient to directors of parent companies.

Paragraph 30 of the Exposure Draft

This paragraph seems to have a very twelve month orientation – indeed even "up to twelve months". Principle 3, rather, is not so limited and talks about "all information about the future".

Lenders will have made facilities available to few firms, however small[2], which do not provide some projection of cash flows well beyond the end of the marked credit. The last bullet of para. 12 refers to lenders expressing an opinion about renewal of a facility in twelve months. This suggests the lender has been provided by directors with cash flow projections for several years. This makes the "up to twelve months" in para. 30 look even odder.

We recognise that it is not desirable that the Guidance set a particular lower time limit or prescribe a particular method. But to say in para. 30 "covering such period as the directors consider appropriate and at least twelve months" would seem more apposite. Of course, proportionality (from Principle 2) guides directors and would help them find the appropriate period.

See also our comment on Question 4, above.

Paragraphs 35 to 38 of the exposure draft

Cash requirements of a firm are not only met from borrowing facilities. They can have invested liquid funds, maturing investments, and so on. Accordingly, we suggest that in para. 37 the words "from such facilities" are inserted after "expected cash requirements".

We also suggest that the wording suggested for para. 30 (above), "covering such period as the directors consider appropriate and at least twelve months", is also substituted in para. 37 for the existing "as a minimum for the period ending twelve months".

Paragraph 40 of the Exposure Draft

In recent months, governments and the European Commission have made proposals to move derivatives from bilateral contracts ("over the counter", OTC) to central counter parties. This can introduce margin requirements or credit support for mark-to-market contingent liabilities.

A company using derivatives for hedging may thus see immediate and substantial cash outflows which will be expected to be offset on maturity of the hedged item – perhaps years away. Meanwhile, this can be a very material risk to company cash flows. Most OTC contracts between companies undertaking hedging activity and their banks do not at present require margin payments, so it will be a new and potentially very large risk for many companies.

It would seem appropriate to add "and margin or other credit support provisions under derivative contracts" to the list in para. 40.

Paragraph 42 of the Exposure Draft

[2] Of course many small firms do not have debt of any kind.

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The increased requirement for derivative contract margining referred to re para. 40, above will alter the timing of cash flows of the company, as the value of derivatives move. Adding a new bullet "margin requirements consequent on varying underlying prices relevant for derivative contracts during their life" may be appropriate.

Paragraph 56 of the Exposure Draft

Section 3 generally reviews the existing requirements from various authorities. Inevitably this useful review does distract from the essential clarity of the Principle 3.

The heading of para. 56 suggests that it is a definitive paragraph. Its wording would suggest to many directors that they should settle for 12 months and not think further ahead. We suggest the insertion of "consider all information about the future that they are aware of and" after "UK companies" in para. 56. Here, the words from Principle 3 would remind readers of that Principle.

See also our comment on Question 4, above.

Paragraph 57 of the Exposure Draft

It would be helpful if the bullet points were modified so that in each case the conclusions set out in para. 20 were first repeated verbatim and then the appropriate disclosure conclusion set out. The stark differences from 20 in 57 are, as presented, just a distraction. (See also answer to Question 3.)

Paragraph 79 of the Exposure Draft

We welcome this paragraph. Sometimes disclosure requirements seem designed to help a board intent on producing a "snow job" of data rather than information. It is good to see the FRC leaning against this. The section heading, "Balanced, proportionate and understandable disclosures" should be a mantra for all setters of disclosure requirements.

Paragraph 84 of the Exposure Draft

We have in mind paragraph 79 of the ED and, particularly, its last sentence which emphasises the circumstances at the date of approval.

The second sentence of para. 84 emphasises companies in financial distress.

However, even where the possibility of financial distress has not arisen, circumstances may mean that the factors taken into account by the directors in relation to the going concern question have materially altered. That should be referred to even if the directors' conclusion is unchanged since the prior year end. Much of the relevant matter will probably have been covered to elsewhere, e.g. in the consideration of risks and uncertainties, and simply can be referenced here in the context of the going concern question.

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The Association of Corporate Treasurers

The ACT is an international body for finance professionals working in treasury, risk and corporate finance. Through the ACT we come together as practitioners, technical experts and educators in a range of disciplines that underpin the financial security and prosperity of an organisation.

The ACT defines and promotes best practice in treasury and makes representations to government, regulators and standard setters.

We are also the world's leading examining body for treasury, providing benchmark qualifications and continuing development through training, conferences, publications, including *The Treasurer* magazine and the annual *Treasurer's Handbook*, and online.

Our 3,600 members work widely in companies of all sizes through industry, commerce professional service firms.

Further information is available on our website (below).

Our policy with regards to policy and technical matters is available at http://www.treasurers.org/technical/resources/manifestoMay2007.pdf .

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