



THE INSTITUTE
OF CHARTERED
ACCOUNTANTS
IN ENGLAND AND WALES

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Your ref:

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Dear Steve

GOING CONCERN AND LIQUIDITY RISK: GUIDANCE FOR DIRECTORS OF UK COMPANIES

The Institute of Chartered Accountants in England and Wales is pleased to respond to your request for comments on the exposure draft, *Going Concern and Liquidity Risk: Guidance For Directors of UK Companies*.

Please contact me if you would like to discuss any of the points raised in the attached response.

Yours sincerely

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ICAEW REPRESENTATION

ICAEW REP 88/09

GOING CONCERN AND LIQUIDITY RISK: GUIDANCE FOR DIRECTORS OF UK COMPANIES

Memorandum of comment submitted in August 2009 by The Institute of Chartered Accountants in England and Wales, in response to the Financial Reporting Council exposure draft, *Going Concern and Liquidity Risk: Guidance For Directors of UK Companies*, published in May 2009

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INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales (the Institute) welcomes the opportunity to comment on the Exposure Draft *Going Concern and Liquidity Risk: Guidance For Directors of UK Companies*, published by the Financial Reporting Council in May 2009.

WHO WE ARE

2. The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 132,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 775,000 members worldwide.
3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The Institute ensures these skills are constantly developed, recognised and valued.
4. Our members occupy a wide range of roles throughout the economy. This response was developed by the Financial Reporting Committee of the Institute, which includes preparers, analysts, standard-setters and academics as well as senior members of accounting firms and public sector bodies.

MAJOR ISSUES

Welcome for the exposure draft

5. We welcome guidance from the Financial Reporting Council on going concern and liquidity risk. We believe that the guidance strikes the right balance between high-level principles and more detailed guidance and will be useful to directors and their equivalents in entities of all sizes, subject to some of our suggestions below.

Applicability to entities other than companies

6. We note that the exposure draft refers throughout to 'companies'. We do not think it is necessary to limit the guidance in this way, as it appears to be equally applicable to other entities, eg LLPs.

Accounts that show a true and fair view

7. We understand why, in paragraph 3 and elsewhere, the guidance links itself to financial statements 'that are intended to give a true and fair view', particularly to distinguish half yearly financial statements from IMSs. There are, however, some areas of concern with this approach around the margins:
 - 'Half-yearly financial statements' prepared in accordance with the DTRs only have to state compliance with IAS 34. There are many that would dispute that such condensed financial statements, as

suggested in Paragraph 56, can give a true and fair view (this objection by investors was why rule DTR 4.2.10(4) was inserted into the DTRs, notwithstanding what is stated in the Transparency Directive). However, it will still be necessary to look forward for a period of 12 months if the interims are drawn up according to policies consistent with the year-end financial statements, regardless of whether the intention is to give a true and fair view.

- AIM and PLUS-quoted companies are not required under their respective rules to provide interim statements that give a true and fair view; they are only required to produce interims that are consistent with the annual financial statements. Yet we assume that the FRC would wish its guidance to apply to these companies' interims, particularly in relation to the 12 month period from the date of the accounts being approved.
 - The FRC has rightly excluded IMSs from this guidance (although going concern problems outside regular reporting periods might need a market announcement anyway for a listed company under DTR2), but what would the FRC wish to see companies doing that produce full quarterly financial statements instead of IMSs, as permitted under the DTRs (DTR 4.3.6)?
8. The end of Paragraph 84 deals with disclosure in interims when the directors have identified no new issues. The fact that nothing has changed may itself be useful information, depending on the circumstances, so the guidance should indicate that there may be a need at least to disclose that this is the case and, depending on the materiality of the uncertainties, to repeat the full year end disclosure.
9. Paragraph 52 refers to smaller companies in the context of interim financial statements. This is potentially misleading, given that 'smaller' is an imprecise term and certain AIM companies might be regarded as 'smaller'. We suggest that his paragraph should be redrafted to refer to companies that are not publicly traded.
10. We suggest that paragraph 53 dealing with the ASB's non-mandatory statement on Half-yearly financial reports would sit better under 'The Review Process'.

The Financial Reporting Standard for Smaller Entities (FRSSE)

11. The draft guidance refers in paragraph 4 and elsewhere (for example, paragraphs 7, 15, 17, 23, 30, 49, 52 and 76) to the Financial Reporting Standard for Smaller Entities (FRSSE) as if it were separate from UK Generally Accepted Accounting Practice (UK GAAP). We do not believe it is appropriate to separate out the FRSSE in this way, since the FRSSE is part of UK GAAP. We suggest the guidance should adopt a formulation that makes this clear; for example (In paragraph 4):

'International Financial Reporting Standards (IFRS) and UK Generally Accepted Accounting Practice (UK GAAP), which includes the Financial Reporting Standard for Smaller Entities (FRSSE).'

Modified audit reports

12. We believe that a clearer explanation of the nature of different modified reports is required up front 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 explained the clear distinction in ISAs 570 and 700 between an emphasis of matter, which does not affect the auditors' opinion, and a qualification, which does, i.e. make clear that a qualification is a subset of a modification, with the important difference being that in a qualification the auditor's opinion is affected. Paragraph 75 should also be drafted to reflect the distinction between matters that affect the opinion and those that do not.
13. In the table in paragraph 20 (row 3 column 3), the exposure draft implies that where the going concern basis is not appropriate and this has been properly explained in the financial statements the auditors will issue an unmodified report. We believe that practice varies in this area, and that often auditors will make an emphasis of matter under ISA 570.36.

UK companies that have adopted IFRS

14. In paragraph 23 the exposure draft refers to 'UK companies that have adopted IFRS' when referring to the requirements of IAS 1. However, the requirements under UK GAAP in FRS 18 are identical and should be included here. Similar considerations arise in paragraph 45 in relation to condensed interim financial statements prepared in accordance with IAS 34. In this case it might help to refer forward to the material on UK GAAP in paragraph 53.

Objective underlying procedures

15. Paragraph 30 implies that entities are required to produce formal cash flow, budget or similar analysis for a period of at least 12 months from the date of approval of the financial statements. However, neither financial reporting standards nor auditing standards state the nature of the information that companies need to produce in support of their going concern assessment. The guidance might be reworded to say that the information prepared should be sufficient for the directors to make their assessment and then provide these as examples.

Small entities

16. Paragraph 30 states that directors should 'prepare a budget, trading estimate, cash flow forecast or similar analysis'. We question the extent to which these techniques are relevant to many small entities, particularly given that ISA 570 acknowledges that alternative sources of evidence may be acceptable. Paragraphs 31 et seq then go on to look at 'Procedures more relevant to medium and large companies'. We note that these procedures cannot necessarily be ignored by small companies. We do not think paragraph 30 is meaningful or helpful for small companies on its own. We believe it would be preferable to set out the general requirements for all companies, and then to explain how they could be applied by small entities on a very practical basis, not just medium and large companies.

17. Paragraph 58 suggests that directors of smaller companies will also need to consider whether other uncertainties need to be disclosed. This is unhelpful, as it suggests that there may be additional requirements applicable to small companies. As set out above, smaller companies are likely to need further guidance in this area and as such any reference to 'uncertainties' could usefully include some examples.

A single note on going concern and liquidity risk disclosures

18. We agree that it is helpful if going concern and liquidity risk disclosures are brought together in a single note to the financial statements. This is important enough perhaps to be elevated from Paragraph 77 to perhaps just after Paragraph 58. In our view, the information in the note itself should be sufficient to provide a clear, comprehensive and cohesive understanding of the issues facing the company. It is therefore desirable to keep cross-references to a minimum. Further, the FRC might wish to consider the problem for auditors if any cross-references are to information outside the financial statements but included elsewhere in the annual report, where that information is not capable of being audited, e.g. management intentions about the future, as that cross-reference effectively brings the information into the scope of the audited financial statements.

Appendix 1 - Examples

19. In Appendix 1, examples 1 to 3 of notes to the financial statements, it is important that each note should deal with auditable information, which may exclude certain factors likely to affect the company's future development set out in the Business Review.
20. Appendix 1, Example 3 includes the words 'The directors have concluded that the combination of these circumstances represent [sic] a material uncertainty that casts significant doubt upon the group's and the company's ability to continue as a going concern.' In line with the guidance in paragraph 65 (and ISA 570.32(b)), it is important that the note should also include a statement that the company may therefore be unable to realise its assets and discharge its liabilities in the normal course of business.
21. Appendix 1, Examples 4 and 5 are too similar. We suggest that an example based on the availability of finance resulting in a material uncertainty that casts significant doubt on the company's ability to continue as a going concern should be substituted for one of them

OTHER MATTERS

22. In Paragraph 16, we suggest replacing 'is likely to be' with 'will usuallybut in rare cases when they do not, they should explain why.'
23. Paragraph 18 as drafted does not make sense and as worded looks as if directors are required to make a statement that the business is a going concern. To reflect the actual requirement of the relevant Listing Rule it should state that 'Listed companies are required by Listing Rule 9.8.6R(3) to provide a statement by the directors that the'. Even then, although this better reflects the wording of the LR, it still assumes the directors will make a

statement that the business is a going concern, whereas of course one of their options under the guidance is to state that it does not.

24. 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. Also, paragraph 57 refers to circumstances in which there is no realistic alternative to liquidation, while omitting the possibilities both of management intent to liquidate and either intent or no realistic alternative to ceasing to trade.
25. 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 such changes are reasonably possible.
26. While we understand the reference in paragraph 42 to 'counterparty default rates', we think it would be helpful to many users of the guidance to provide an explanatory example, such as 'the risk of a major customer failing'.
27. The section on Directors' Reports (paragraphs 59 et seq) could usefully be augmented by including the relevant material from DTR 7.2.
28. It would be helpful if paragraph 62 made it clear that it is permissible to cross-refer from the Directors' Report to the relevant item in the accounts.
29. It might be worth reviewing sections two and three again as it seemed to us that some of the text currently included in section two would fit better into section three.
30. In Appendix II, it would be helpful to add a section for small companies, not just focusing on medium and large ones. And at the very least, add a sentence at the end of the first paragraph to say that smaller entities may do much the same, but simpler procedures may be better suited to their situation.

SPECIFIC 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?

31. Yes. We agree that the FRC should provide guidance on going concern for directors of all companies, and that the Exposure Draft achieves this in a reasonably balanced way.

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

32. We agree with the principles as drafted except that:
 - In Principle 1 (and paragraph 14) the words 'a formal and rigorous assessment' are rather unhelpful, particularly for small companies,

without some explanation and an acknowledgement that larger, more complex organisations require more than small, simple ones.

- For Principle 3, the issue raised above (in paragraph 7) in relation to whether the guidance should always only apply to true and fair accounts needs to be addressed.

33. We particularly applaud the focus in Principle 3 on the need to consider a period of one year from the date of approval of the financial statements.

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

34. We agree that there should be three conclusions, which should be those set out in the exposure draft.

35. However, we believe the guidance should make it clear that even where there are no material uncertainties some disclosure may nevertheless be required in order for the financial statements to give a true and fair view. We suggest that the table in paragraph 20 (row 1 column 2) should emphasise that the extent of disclosure will vary depending on the nature and extent of the uncertainty. This could be augmented by an explanation of the difference between example 1 and example 2.

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?

36. Yes. We agree that the guidance should press for this disclosure.

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?

37. Yes.

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