ICAEW REPRESENTATION 11/16

Guidance on the Going Concern Basis of Accounting and Reporting on Solvency and Liquidity Risks

ICAEW welcomes the opportunity to comment on the *Guidance on the Going Concern Basis of Accounting and Reporting on Solvency and Liquidity Risks* published by Financial Reporting Council (FRC) in October 2015, a copy of which is available from this link.

This response of 21 January 2016 has been prepared on behalf of ICAEW by the Financial Reporting Faculty. Recognised internationally as a leading authority on financial reporting, the Faculty, through its Financial Reporting Committee, is responsible for formulating ICAEW policy on financial reporting issues and makes submissions to standard setters and other external bodies on behalf of ICAEW. The Faculty provides an extensive range of services to its members including providing practical assistance with common financial reporting problems.

The Institute of Chartered Accountants in England and Wales
Chartered Accountants' Hall
Moorgate Place
London
EC2R 6EA UK

T +44 (0)20 7920 8100
F +44 (0)20 7920 0547
DX 877 London/City
icaew.com

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MAJOR POINTS

Support for the initiative

1. Although we make a number of suggestions for improvement below, some of them important, we commend the FRC for producing a broadly sound and proportionate piece of draft guidance and for listening closely to the views and concerns of constituents when taking decisions about its proposed scope and content. Our comments below should be read with this general support in mind. We encourage the FRC to finalise and publish the updated guidance on this important topic without undue delay, and stand ready to help with this process.

Scope of guidance

2. On balance, we agree with the proposed scope of the guidance. However, while we agree in principle that the guidance "is not primarily directed at" small and micro companies, this language is too open to interpretation. The guidance should state for the avoidance of doubt that on the grounds of proportionality, and particularly in view of the very different regulatory regime now applicable to such companies, both small and micro companies are outside its scope.

3. This does not mean the FRC should also feel obliged *ipso facto* to exclude from the guidance any reference to these types of companies where this might be of help to those who understandably find the current legal position confusing following the implementation in UK law of the new accounting directive. For example, as discussed below, the guidance might usefully pinpoint certain sections that directors of small and micro companies might find relevant.

Guidance and legal requirements: a blurred distinction

4. We strongly recommend that the guidance is redrafted to distinguish better between those elements that are mandatory requirements of law and accounting standards, making clear any variances for different sizes of company, and those that provide 'guidance' on how to comply with those requirements. This could, for example, be summarised in tabular format at the start of the guidance, with cross references to the later, more detailed sections.

5. The FRC should also review carefully the language used in the guidance to ensure that the distinction between descriptions of mandatory requirements and guidance on applying those requirements is clear. At present, there is a particularly unhelpful mix of ways in which the word 'should' is used. In some places it is used to refer to a legal requirement, whereas elsewhere it is used in the context of FRC guidance. This needs to be reviewed and remedied.

6. Amending the guidance in this way would help clarify its scope. It would minimise the possibility that what is intended to be non-mandatory guidance in practice imposes additional requirements beyond the requirements of law and standards. In addition, it would make the guidance more helpful. Clearly establishing, at an early stage, the relevant legal requirements for different types of company – for example, micro, small, medium and large, AIM and other listed companies not applying the Code – will help those using the guidance to understand the regulatory context.

Consulting users

7. Distinguishing more clearly between material on mandatory legal requirements and corresponding FRC 'guidance' may also make the document a more effective tool for companies and their advisors, and – crucially – one more likely to be utilised in practice. However, we suggest, in addition, that before it is finalised there is further discussion of the guidance with those who stand to benefit from improved disclosure of going concern and related risks – such as lenders – to ensure that they agree that the approach proposed will provide information that assists them in making decisions based, at least in part, on a company's financial statements.

Clear and concise

8. The guidance is directed at directors, rather than audit firms and financial reporting professionals. It is therefore very important for the FRC to revisit the language used throughout the guidance, ensuring that it is clear and concise, and eliminating any unnecessary complexity and repetition. We set out below in response to question 6 the drafting issues identified during our review.

Period of assessment

9. As explained in our response to question 3 below, we have serious concerns over the proposal that the assessment of solvency risks and liquidity risks should, except in rare circumstances, be 'significantly longer than 12 months from the approval of the financial statements.'

10. The guidance as currently drafted appears to go beyond what is required, and can be expected, from many of the private companies that will be applying it. While it is perfectly reasonable for the guidance to encourage directors, where possible and appropriate in the circumstances of the business, to consider a period significantly longer than 12 months from the approval of the financial statements, we believe the emphasis in the guidance as currently drafted is wrong. The emphasis should be on directors determining an appropriate period of assessment ie, by looking at the relevant business cycles and business models, and it would be helpful for the avoidance of doubt for the FRC to acknowledge that in practice this will often not exceed 12 months.

RESPONSES TO SPECIFIC QUESTIONS

Question 1:

Do you agree with the scope of the guidance as set out in section 1?

11. On balance, we agree with the proposed scope of the guidance. However, while we agree in principle that the guidance "is not primarily directed at" small and micro companies, this language is too open to interpretation. The guidance should state for the avoidance of doubt that on the grounds of proportionality, and particularly in view of the very different regulatory regime now applicable to such companies, both small and micro companies are outside its scope.

12. The draft guidance goes on to explain that "there may be some aspects that are of relevance" to small and micro companies. We agree that the formal exclusion of small and micro companies from its scope does not mean the FRC should also feel obliged *ipso facto* to exclude from the guidance any reference to these types of companies where this might be of help to those who understandably find the current legal position confusing following the implementation in UK law of the new accounting directive. Indeed, we explain below in our response to question 2 that summarising the different legal requirements applicable to different types of company may be useful to companies of all sizes – including small and micro companies – wishing to better understand the regulatory context.

13. It is also not unreasonable to pinpoint sections of the guidance that directors of smaller companies seeking help or reassurance in this difficult area might find relevant. In doing this the FRC should distinguish more clearly between micro and small companies, given the very different regulatory requirements that apply to small companies on the one hand and micro companies on the other. For example, we point out below in our response to question 6 that paragraphs 3.13 to 3.17 may be helpful to a small company if the directors determine that additional disclosures are required in order to show a true and fair view.

Question 2:

Is the guidance sufficient for the different types of company that fall within its scope?

14. We strongly recommend that the final guidance is redrafted to distinguish better between those elements that are mandatory requirements of law and accounting standards, making clear any variances for different sizes of company, and those that provide 'guidance' on how to comply with those requirements. This could, for example, be summarised in tabular format at the start of the guidance, with cross references to the later, more detailed sections.

15. The FRC should also review carefully the language used in the guidance to ensure that the distinction between guidance and descriptions of mandatory requirements is clear. At present, there is a particularly unhelpful mix of ways in which the word 'should' is used. In some places it is used to refer to a legal requirement, whereas elsewhere it is used to describe guidance. This needs to be reviewed and remedied.

16. Amending the guidance in this way would help clarify its scope. It would minimise the possibility that what is intended to be non-mandatory guidance in practice imposes additional requirements beyond the requirements of law and standards. In addition, it would make the guidance more helpful. Summarising briefly at an early stage the different legal requirements applicable to different types of company – for example, micro, small, medium and large, AIM and other listed companies not applying the Code – may help those using the guidance to better understand the regulatory context and pinpoint sections that are most relevant.

17. Distinguishing more clearly between material on mandatory legal requirements and corresponding FRC 'guidance' may also make the document a more effective tool for companies and their advisors, and – crucially – one more likely to be utilised in practice.

Question 3:

Do you agree with the draft guidance on the assessment of solvency and liquidity risk as set out in paragraphs 4.1 to 4.6?

18. While we agree that it is helpful for the guidance to cover both liquidity risk and solvency risk, the material in section 4 could be presented more clearly. In particular, the guidance on solvency risk is incomplete and does not provide a clear picture to directors of what solvency means in practice. The guidance appears to suggest that solvency can be determined by reference to the balance sheet alone ie, it notes that solvency risk is 'the risk that a company will be unable to meet its liabilities in full'. In fact, the law in this area is far more complex, taking into account additional assets and liabilities not recognised on the balance sheet.

19. It might therefore be more helpful for solvency risk to be discussed in more practical terms, perhaps by explaining that while insolvency is one way in which a company may be required to cease trading/liquidate, this will normally be preceded by problems with a company's liquidity. It might also be helpful, when referring to solvency risk, to refer to the relevant sections of the Insolvency Act.

20. Moreover, as explained above, we have serious concerns over the proposal that the assessment of solvency risks and liquidity risks should, except in rare circumstances, be '*significantly longer than 12 months from the approval of the financial statements.*' The guidance appears to go beyond what is required, and can be expected, from many of the private companies that will be applying this guidance. While it is perfectly reasonable for the guidance to encourage directors, where possible and appropriate in the circumstances of the business, to consider a period significantly longer than 12 months from the approval of the financial statements, we believe the emphasis in the guidance as currently drafted is wrong. The emphasis should be on directors determining an appropriate period of assessment ie, by looking at the relevant business cycles and business models, and it would be helpful for the avoidance of doubt for the FRC to acknowledge that in practice this will often not exceed 12 months.

Question 4:

Does the draft guidance sufficiently distinguish between the assessment of and reporting on the 'narrow' going concern basis of accounting (section 3) and the broader concept of solvency risk and liquidity risk (section 4)?

21. Yes, we broadly agree that the guidance sufficiently distinguishes between the assessment of reporting on the going concern basis of accounting and the broader concept of solvency risk and liquidity risk. However, there may be scope for confusion where there is a close interaction between the reporting requirements of the two sections. For example, draft paragraphs 3.15 to 3.17, within the section dealing with the going concern basis of accounting, discuss the liquidity risk disclosure requirements under FRS 102 and IFRS 7. However, the discussion of material risks to a company's viability set out in draft paragraph 4.15 of the solvency and liquidity risks section might be equally relevant to the assessment of the going concern basis of accounting and material uncertainties.

Question 5:

Does the draft guidance adequately highlight the relationships between the concepts (section 2)?

22. Yes, the draft guidance helpfully highlights the relationship between the legal requirements for disclosures in the strategic report, the legal requirements concerning the going concern basis of accounting, and the requirements in accounting standards for disclosures on the going concern basis of accounting. However, we are not sure how helpful Figure 1 in Section 2 really is. In particular, it is not clear to us why it differentiates between 'Principal risks' and 'Principal risks, including liquidity and solvency, impacting viability.'

Question 6:

Do you consider that the guidance is sufficiently practical? If not, how might the guidance be improved?

General – drafting and language

23. As noted above, it is very important for the FRC to revisit the language used throughout the guidance; ensuring that it is clear and concise, and reducing any unnecessary complexity and repetition. We set out below the drafting issues identified during our review:

- Paragraph 5.4 currently states that 'if there is uncertainty over the contractual arrangements with lenders and other providers of finance, directors should seek confirmation from lenders of the principal terms and conditions.' We find this rather vague. We believe the intention of the guidance is to highlight instances when directors may be uncertain about changes in contractual arrangements and therefore recommend that this is rephrased to 'if there is uncertainty over the *variation* in contractual arrangements…'

- Paragraph 5.15 notes that 'the onus is on the directors to be satisfied that there are likely to be appropriate and committed financing relationships in place.' In our view, use of the word 'committed' might be create problems in practice and asks too much of directors. We suggest that this is rephrased to '…likely to have adequate finance in place.'

- The definitions of liquidity risk and solvency risk are repeated in Sections 4 and 1. We suggest that they only appear once, with cross references where necessary.

- Paragraph 6.4 largely repeats the information provided in paragraph 6.2. A more concise approach might be to include any relevant information from paragraph 6.4 as a footnote to 6.2.

Section 3: Going concern basis of accounting and material uncertainties

24. We have some concerns over the processes referred to in Section 3, which sets out how directors should assess whether the adoption of the going concern basis of accounting is appropriate.

25. Firstly, paragraphs 3.5 and 3.12 require directors to consider 'all available information about the future' when carrying out this assessment. This statement is too sweeping and may therefore lead to uncertainty about the degree to which directors have to seek out information that may have some bearing on the future prospects of the business. We recommend that the FRC revisits the drafting of these paragraphs.

26. Secondly, as explained above, it would be helpful to include a footnote to paragraphs 3.13 to 3.17 to highlight that these additional paragraphs may also be relevant to a small company if the directors determine that additional disclosures are required in order to show a true and fair view. At present, the guidance only states that paragraphs 3.1 to 3.12 may be useful for small and micro-companies when assessing whether the going concern basis of accounting is appropriate.

27. Finally, paragraph 3.4 requires that this assessment should be 'documented' by directors in order to explain the basis of their conclusion. As it stands this requirement is likely to cause uncertainty about the extent to which directors must provide and retain evidence for their assessment. This should be reconsidered by the FRC before finalising the guidance.

Section 4: Solvency and liquidity risk

28. See our response to question 3.

Section 5: The assessment process

29. We agree that sensitivity analysis can potentially be very helpful and should be included in the guidance as a possible tool for companies. However, we do not find paragraphs 5.7 and 5.8 very useful, particularly the list of factors that might be tested when performing sensitivity analysis.

30. For example, the list refers to market share, although it seems unlikely that this would be a relevant factor for these purposes. It is not clear what is meant by '*margin requirements consequent on varying underlying prices relevant for derivative contracts during their life*.' We recommend that this is rephrased using more clear and understandable language. And finally, the list refers to 'expected selling costs' when we would have expected this to be 'expected selling prices.' This list should be reconsidered and, where necessary, rephrased to be more helpful.

31. Paragraphs 5.17 and 5.18 do not cover other types of risks that may affect a group, for example, group borrowing facilities that may be in place or group guarantees. It may be helpful for the FRC to expand these paragraphs to cover a wider range of risk factors that may be relevant in group situations.

Section 6: Materiality and placement of disclosures

32. We have no comments.

Section 7: Auditor reporting

33. We have no comments.

Appendices

34. Section A1 of Appendix A covers the application of the guidance to half-yearly reports. In our view, a simpler and more concise approach would be simply to cross refer to the relevant section of the guidance for companies applying the UK Corporate Governance Code.