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The Sharman Secretariat
c/o Financial Reporting Council
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By email: sharman.secretariat@frc.org.uk

Dear Lord Sharman

Going concern and liquidity risks: Lessons for companies and auditors

ICAEW is pleased to respond to your request for comments on the call for evidence *Going concern and liquidity risks: Lessons for companies and auditors*.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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ICAEW REPRESENTATION

GOING CONCERN AND LIQUIDITY RISKS: LESSONS FOR COMPANIES AND AUDITORS

Memorandum of comment submitted in June 2011 by ICAEW, in response to the Sharman Inquiry call for evidence *Going concern and liquidity risks: Lessons for companies and auditors* published in May 2011.

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INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the call for evidence *Going concern and liquidity risks: Lessons for companies and auditors* a call for evidence from the Sharman Inquiry on 11 May 2011. A copy of this call for evidence is available from this link.

WHO WE ARE

2. ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter which obliges us to work in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 136,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained. Being the only professional body to be invited to join the World Economic Forum is testimony to our range and authority as an international commentator and contributor to public policy debates.

3. ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value. Over half of ICAEW's members work in business (ie, outside public practice) with approximately a third of business members working in SMEs. Positions held range from being Chairman, CEO, CFO or Audit Committee Chair of a major listed company to being an owner-manager of a small business.

4. ICAEW's views, as expressed in this submission, are drawn from consultation with and input from its broad membership and engagement with other stakeholders and are developed specifically with the public interest in mind. In preparing our response, we have engaged with market participants and professionals in diverse fields. In the following paragraphs we summarise the major themes arising from our broad consultation process. These underpin our answers to the specific questions asked by the Inquiry.

MAJOR POINTS

Clarity about what the review is trying to achieve

5. While it is entirely appropriate for the FRC to review the lessons learned from the crisis in relation to going concern reporting and auditing, we are concerned that the objectives of the review should be clear. Whatever further measures are taken in this area in relation to financial reporting and auditing will not stop companies failing and shareholders losing their investment; that is a natural consequence of a market-based economy. Limited liability allows the losses to be contained for shareholders and creditors have means of securing their lending, but losses will occur. Attempting to intervene to prevent the failure of companies by providing some kind of guarantee of future solvency is unlikely to be effectual yet the cost of doing so would be considerable. We are concerned that this review and any proposed FRC actions should not extend an 'expectation gap' that already appears to exist in relation to what people think a going concern review and a related audit report actually deliver.

6. Moreover, the areas of corporate governance, auditing and financial reporting contained in the call for evidence are not uniquely being considered by the present Inquiry. In considering the results of this consultation it would be useful to bear in mind the findings of the FRC's other initiatives, *Effective Company Stewardship* and *Cutting Clutter* as well as others being undertaken at an EU and international level. Primarily it is of great importance that any actions arising from this body of investigation are coordinated and coherent in their implementation, and that they are proportionate. Ultimately, where regulatory change is to take place it is imperative that this offers real net benefits and does not merely burden companies with incremental regulation. The capital markets benefit where transparency is enhanced through the provision of specific and targeted information that helps users to better assess risk. And proportionate and targeted risk disclosures, by improving discipline, can also help entities themselves to better manage going concern risk, thereby actually adding value. It is important that any regulatory change does deliver genuine benefits of this kind that exceed the costs of compliance.

The current going concern framework works well for the purposes of producing annual accounts

7. The assessment of and reporting upon going concern is an integral element in the production of annual accounts for all companies, and it is essential therefore that regulation in this area be proportionate and practical to apply. Overall we believe that the current UK regime for assessing and reporting on going concern and liquidity risk achieves this well. The regime has evolved positively in recent years and the FRC's latest guidance, released in 2009 provides a proportionate and generally sound framework. Indeed the UK regime is more comprehensive and demanding than that in place in other countries. This assessment and reporting framework is underpinned by the fiduciary responsibilities of directors, enforced by a series of legal remedies should these be negligently or criminally discharged. For the purposes of preparing the annual accounts therefore, we do not believe that any change to the current framework is either desirable or necessary. Where further investigation is merited however is in a broader examination of the gap between users' expectations and the messages about going concern that the annual report and accounts actually communicate.

A focus on entities with a higher degree of public accountability

8. For the overwhelming majority of UK entities where ownership and management are closely connected, the current regime remains fit for purpose. Indeed these entities are unlikely to be affected by the 'expectation gap' that entities with a large number of external stakeholders experience. The call for evidence is not explicit with regard to the type of entity the Inquiry is aimed at and consequently it would be useful for its focus to be more clearly defined. We do not believe that there is a compelling case for any regulatory change for entities not seen to have a higher degree of public accountability and we do not accept that the costs of such changes are likely to be justified. Therefore we suggest that entities of this type be excluded from any action to address the 'expectation gap'.

Disclosure should be re-focused on key short-term going concern or liquidity risks and the entity's sensitivity to them

9. For entities with a higher degree of public accountability (for example listed companies) however, we believe that users could benefit from a greater insight into an entity's management of going concern risk. For these entities therefore, we think that the existing accounts objective would be better served if going concern disclosures were refocused to cover key risks to the entity's liquidity or solvency in the short term. In our view these disclosures should communicate:

- the specific going concern or liquidity risk factors (if any) that might cause the company to fail;
- how management has gone about assessing these risks and what they have concluded; and
- the sensitivity of the company to each of these risks, ie. the extent to which the accounts date situation would have to change before the risk became critical;

10. A core objective of this disclosure would be to allow users of accounts to assess management's thinking in concluding upon going concern. This would facilitate the development by users of a more detailed understanding of going concern and liquidity risk factors thereby potentially alleviating or averting market surprise, and even panic, should any of these factors move against the entity.

11. Audit committees also have an important role to play. We were generally supportive of the proposals in the recent FRC paper *Effective Company Stewardship* for more information to be made available by audit committees about their discussions with auditors; such information will commonly include any significant matters regarding going concern risk.

Our preference is for better rather than more disclosure

12. Nevertheless, while some targeted improvements could be made to going concern disclosures as outlined in paragraph 9 above, these should not be introduced to the detriment of the clarity or coherence of reporting. We are supportive of the FRC's project *Cutting Clutter* and urge the Council, should it consider enhancements to going concern disclosures necessary, to bear in mind the outcome of that project. More disclosure certainly does not necessarily equal better disclosure, particularly if that disclosure is in the form of 'boiler plate' text and therefore it is important that any enhancement to disclosure takes the form of targeted and relevant company specific information.

The purpose of the going concern statement in the annual accounts is different from that of the working capital statement

13. To reiterate, we do not believe that a change to the current going concern basis would be appropriate. At present, the accounting convention of going concern is employed to avoid the undesirable situation whereby assets have to be marked down to their disposal value at the end of an accounting period; as such it enables the production of meaningful accounts. The use of the going concern basis of accounting is abandoned only if there is no realistic alternative to failure. While a rigorous exercise is employed by the directors to determine whether or not the company is in that situation, this exercise is not designed to be a guarantee of future solvency and liquidity. To provide such a guarantee, or a near approximation to it, would require a quite impractical level of analysis, appropriately tailored for each legal entity, and could also require otherwise unnecessary future funding lines to be agreed. The cost of all of this would be considerable. A much more demanding exercise is performed for the purposes of the working capital statement prepared as part of a fundraising, and the required threshold for going concern in this instance is 'near certainty'. However, this situation is quite distinct from the preparation of the annual accounts. In a fundraising the preparatory work acts as a qualifying bar. If an entity is unable to clear this bar then, quite rightly, it is not able to continue with the fundraising. A threshold of this kind (ostensibly a pre-condition for being in business) would neither be desirable nor appropriate for the preparation of annual accounts, which are merely a function of incorporation.

14. However, notwithstanding these considerations, the existence of an 'expectation gap' means that readers of annual accounts may expect the same level of scrutiny to have been performed in that document as in the working capital statement. To counter this therefore, we believe that there is a role for education in any efforts to improve the going concern regime such that the 'expectation gap' may be narrowed. It should be borne in mind that situations of impaired solvency or liquidity can easily be exacerbated where market panic ensues because participants were not expecting these developments. Education could go some way toward addressing this.

RESPONSES TO SPECIFIC QUESTIONS

Transparency of going concern and liquidity risk

1. What combination of information about:

- **the robustness of a company's capital;**
- **the adequacy of that capital to withstand potential losses arising from future risks; and**
- **the company's ability to finance and develop its business model,**

would best enable investors and other stakeholders to evaluate the going concern and liquidity risks that a company is exposed to? How effectively do current disclosures provide this information?

15. It is natural that the spotlight should now focus on going concern reporting following the financial crisis of recent years, and we welcome this opportunity for reappraisal. At the outset, it should not be overlooked that the UK has in place at present a good and proportionate framework for addressing going concern and liquidity risk and that the disclosure requirements in the UK already go beyond those in many other countries. Bringing together the requirements of company law, accounting standards and the listing rules with additional application assistance, the FRC's guidance *Going Concern and Liquidity Risk,* is a well regarded framework for assessing and reporting upon these risks. This framework has generally served the capital markets well. The fact that this guidance is not prescriptive in approach is particularly beneficial as it enables the document to be applied proportionately and in a tailored fashion to an entity's individual circumstances. This is important because a 'one size fits all' mandated approach would be most inappropriate in this area. The current regime is well designed for the purpose for which it was intended - to facilitate the production of annual accounts. For most UK entities, which do not have significant numbers of external stakeholders, the regime is fit for purpose and change is unnecessary.

16. However, for entities with a higher degree of public accountability, a key shortcoming in the current system is that there remains an 'expectation gap' between users and preparers. The public expectation tends to be that the going concern assessment provides a strong indication about the health and future viability of the company whereas the actual requirement is for an assessment as to whether it is appropriate to prepare the financial statements as a going concern, on the basis that survival is a realistic outcome. Clearer articulation of the requirements (and therefore the inherent limitations) in relation to going concern may help to address this expectation gap. However, although education is one factor which the FRC may wish to consider, the clarity of the message is also often insufficient, the relevant information being either scattered throughout the annual report and financial statements or hidden behind other less useful disclosures. There would, therefore, be merit in improving the understanding or absorption of the information relating to going concern and liquidity that is already provided in accounts and indeed outside of the accounts on company websites. In some cases (and Northern Rock is one example) the risks to which the organisation was exposed were in fact plainly disclosed, but in order to comprehend them various pieces of information needed to be extracted from different parts of the Annual Report and company website and analysed. It must also be added however, that in other cases the pre-failure accounts may not have indicated any significant liquidity or solvency risk factors.

17. Further to this, the deficiency of the current disclosures is that they do not allow users to evaluate the quality of management's going concern assessment, or how much 'headroom' there is against the identified risk factors. Therefore we feel that for those companies with a higher degree of public accountability – for example listed companies, it would be useful to re-focus going concern and liquidity risk disclosures. This could be achieved through the inclusion in the accounts of a brief (and half a page appears a sensible target) stand-alone summary of the principal short term risks to liquidity and solvency and a description of the process by which the Board has made its going concern assessment. The objective of this new form of risk disclosure would be to facilitate the evaluation of management thinking, to understand the key factors that management are concerned about in assessing liquidity and going concern risks and the ways in which these may come to have an effect. To achieve this the focus of the Directors' going concern statement could be changed slightly to provide an explanation of:

- what (if any) specific factors might reasonably be expected / changes could reasonably occur, which might cause the company to fail;
- the sensitivity of each of these risk factors eg, the extent to which the accounts date situation would need to change before the risk became critical; and
- the process followed by management in making the going concern assessment (which forecasts were used, how far out these went, what sensitivities were applied, etc).

18. We also appreciate the importance of the disclosure of longer term risk factors, as relevant to the reporting entity, and believe that these also have an important role to play in helping users to assess going concern and liquidity risk. Disclosures of key risks however, are already a requirement for the Directors' report and as such this should already be expected to include any significant and relevant factors pertinent to an assessment of going concern or liquidity risk. Therefore we do not believe there is any specific need for change in this area, but in paragraph 27 below we do suggest that some research be performed into recent corporate failures to determine the extent to which the pre-failure accounts provided forewarning of the difficulties subsequently experienced.

19. Notwithstanding the suggestions above however, we would not support any overall lengthening of the annual report or financial statements. As a result of the accretion of incremental disclosure over the years, part of the problem at present in assessing going concern is that there has been a tendency for the annual report to become overly long. In seeking to improve the reporting of going concern it is our opinion that the Inquiry should focus on the quality of the reported information rather than its quantity. We would particularly welcome coordination between the conclusions of this Inquiry and the FRC's wider projects on *Effective Company Stewardship* and *Cutting Clutter* as well as with the other, similar, projects being undertaken at an EU and international level. Appropriately focused and cross-referenced, business specific risk analyses are to be welcomed, whereas boiler-plate disclosures are not. 'More disclosure' is not necessarily 'better disclosure'.

20. We recognise that calls have been made from some quarters for deeper reform of the going concern reporting framework beyond the requirement expressed above (ie, raising the bar rather than addressing unrealistic expectations). Indeed some have suggested that there should be an incremental reporting requirement, explicitly along the lines of providing greater comfort as to the future viability of the business. This is envisaged to perhaps be done through requiring completion and publication of a working capital adequacy assessment, or even at an extreme by the publication of companies' internal forecasts. However, incremental process or disclosures would not mean that the future of the company was assured, nor that the audit represented a guarantee of the financial health of the entity, and at the same time such developments may have the danger of increasing or creating a new expectation gap. On balance, we consider that the suggestions we have made in paragraph 17 above would help achieve much the same end result more cost effectively and without the risks of disclosure of commercially confidential information, the threat of which may constrain management analysis and decision-making.

21. The role of the audit committee and the auditors should be considered in assessing the best way to address the needs of users. As we made clear in our response to the FRC's recent *Effective Company Stewardship* consultation, ICAEW supports emphasising the role of audit committees and the need for greater transparency of their activities. Generally, we are supportive of more information being made available by audit committees about their discussions with auditors which will include significant matters regarding key risks and going concern. Audit committee disclosure could also include a description of the process by which the committee considered the appropriateness of the going concern basis for accounts – information reviewed, sensitivities considered, etc – taking care to avoid any duplication of reporting.

22. We also feel that the results of the current Inquiry should be considered holistically with those from *Effective Company Stewardship* and *Cutting Clutter* consultations that are highly relevant to the current exercise. Specifically any changes that result from either enquiry should be weighed together to determine their overall effects. We particularly see merit in the proposal in *Effective Company Stewardship* for greater transparency regarding the key issues that are considered in the communication between external auditors and audit committees but consider that it is appropriate for such disclosure to be made in an audit committee report rather than the external audit report. With respect to our proposal in paragraph 17 above for a re-focusing of going concern disclosures, careful consideration will need to be given as to the implications for the auditors ie, what level of assurance would be desirable and practicable for such information. If an assurance opinion is to be given, there should be suitable criteria to assess the information. If suitable criteria are given in the form of reporting guidance/rules, these 'rules' would need to be examined to assess whether they satisfy the characteristics of 'suitable' criteria for assurance purposes.

23. It should also be noted that although Question 1 references 'investors and other stakeholders' as the audience of going concern and liquidity disclosures, the parties most interested in them are likely to be lenders, secured or otherwise, and anyone contemplating extending credit to the entity in future.

2. What type of disclosures (if any) have been made into the market place outside annual and interim corporate reports about current stresses being experienced by the company and about the management of those stresses? How do these disclosures interact with the requirement to disclose principal risks and uncertainties in the Business Review and the required disclosure on going concern and liquidity risk in the annual and interim financial statements?

24. For listed and quoted entities there is currently a requirement to disclose inside or price sensitive information to the market as soon as possible, and consequently where an entity becomes aware of a material threat to its liquidity or solvency it is to be expected that this would be disclosed. However, we do not have evidence of the timely release of such information and some study of this (as suggested in paragraph 27 below) might be worthwhile. This question appears to be phrased in the context of quoted companies, but unquoted companies will not have the same reporting obligations and, to the extent that it necessary to include them in the present Inquiry at all, should be considered separately in terms of how users obtain information on going concern outside the financial statements.

3. Are there any barriers within the current corporate reporting environment to companies providing full disclosure of the risks associated with going concern and liquidity both within and outside the company's annual and interim reporting? Are there any changes that might be made to encourage companies to give fuller and more transparent disclosures in this respect?

25. We have set out in paragraph 17 above how we believe the current disclosure could be improved within the context of annual reporting.

26. The trading statement is the primary method for communicating with the market outside of the context of annual or interim reporting, supplemented by disclosures under the continuing obligations as described in paragraph 24 above. However, in practice using these statements to warn of going concern or liquidity risks is problematic. Such disclosures, particularly in the case of financial institutions, are seen by entities as likely to become a self-fulfilling prophecy; as soon as it is known that a particular entity has solvency or liquidity problems it is quite likely that this would exacerbate the entity's problems and potentially bring about an insolvency that could have been avoided. Consequently these statements are rather blunt instruments when it comes to going concern. On the other hand, this should not be a justification for not making appropriate disclosures required by the Disclosure and Transparency Rules (DTR). The biggest impediment here is that the release of sudden or unexpected news can lead to panic, it may be that the provision of more informative risk disclosure such as we have suggested in paragraph 17 may allow better stakeholder anticipation of potentially risky developments and therefore lessen the surprise element if the situation deteriorates. Encouragement of earlier disclosure will decrease this ‘surprise’ element which might otherwise lead to panic.

27. It might also be useful for the FRC to consider conducting research on a number of the high-profile insolvencies of recent years to compare the disclosures in the financial statements (and otherwise to satisfy the continuing obligations under the DTR) with the circumstances identified in the administrators’ report. This would allow an evaluation of the information disclosed and of its predictive value (or, indeed, to identify inadequacies in disclosures which might in the circumstances have been expected). Such research would, we feel, be relatively easy to conduct. Furthermore, the Inquiry might also wish to review the frequency of emphasis-of-matter paragraphs and what happens to companies following the publication of these, eg how many of these companies become insolvent and what the reaction of users is when they read these emphasis-of-matter paragraphs.

4. Given the current measurement, recognition and disclosure requirements of International Financial Reporting Standards (IFRS), how effective are IFRS financial statements in enabling stakeholders to evaluate the robustness of a company’s capital in the context of the going concern assessment? Are there any changes that could be made to these requirements that would better enable them to do so?

28. The disclosures currently required by IFRS of an entity’s capital position are extensive and clearly show how that capital is structured. Different capital structures carry different degrees of risk, but the current accounting requirements are adequate to facilitate users’ assessment of this and therefore we do not perceive any particular deficiencies in IFRS in this regard. Ultimately IFRSs are not intended to be a guide to future financial health, but to present the financial position at a particular point in time. Moreover, we question the usefulness in this context of the concept of ‘robustness of capital’; capital adequacy is an important consideration for financial institutions but is of less relevance to other corporate entities. After all, most corporate failures occur because a company runs out of cash – not because of a measure based upon accounting numbers such as capital inadequacy and therefore we are unconvinced that this is the right focus. Moreover, capital adequacy is a regulatory requirement, a pre-condition of being in business applied to financial institutions as a result of their business model, not a test that it would be appropriate to apply more widely. It may therefore be helpful for any analysis to be segmented between the financial and corporate sectors (and sub-sectors within each if necessary). In any event, we note that regulatory capital in the financial sector uses accounting measures only as a starting point. Adjustments can be made, and are made.

Company assessment of going concern and liquidity risk

5. What processes are undertaken by directors in making their assessment of whether the company is a going concern when preparing annual and half-yearly financial statements?

- **Which records and information are referred to in making this assessment?**
- **What type of model does the company use to develop scenarios to stress-test the assumptions that have been made when making this assessment?**
- **What types of risks are included in the going concern assessment: financial, strategic, operational, other? How are these presented in the assessment?**

29. The processes that entities follow in making their assessment of going concern are necessarily bespoke to the circumstances of that individual entity. Therefore we do not believe it is appropriate for us to generalise to this level of detail, although individual companies may be able to provide you with some information from their own perspective.

- **What is the role of the audit committee and risk management committee (where one exists) in this process and what inputs do they receive in order to carry out this role?**

30. The role of audit committees and the auditors is covered in paragraph 21 above and in our answer to question 11 below.

- **What impact has undertaking the going concern assessment had on the planning and management of the company?**
- **How has the assessment of going concern and liquidity risks been incorporated into other aspects of company stewardship and reporting?**

31. Over the past few years since the beginning of the financial crisis we feel that generally management awareness of going concern and liquidity risks has increased and that accordingly this has led to a greater focus by management on the assessment and subsequent reporting of going concern.

- **How effective is this assessment in addressing the robustness and adequacy of a company's capital and its ability to continue financing and developing its business model? What, if any, improvements could be made?**

32. Please see our comments in paragraphs 15 - 23 above.

6. What is different about the review of going concern when raising capital compared to the annual going concern assessment undertaken for accounting purposes? Could some of the different procedures be used in the annual accounting or audit assessments?

33. The relevant guidance to be followed in the preparation of a working capital statement is contained within *Prospective Financial Information: Guidance for UK directors,* published by ICAEW. We do not believe there is a significant difference in the principles behind the processes that are gone through for each of the two exercises. Where the two do differ is in the level of certainty required from the exercise. The bar is rightly set higher in a capital raising situation, where investors are being asked for fresh funds, and the fundraising is therefore conditional upon the working capital exercise. This then has the result that the work required is significantly more extensive. In a public fund raising exercise, directors should only make a clean working capital statement where there is very little risk that the statement will subsequently be called into question. The UK listing authority (UKLA) requires that the statement made is a strong assertion and any disclosure of key assumptions or caveats linked to the working capital statement including in the risk factor section are challenged by the UKLA as a potential qualified working capital statement. There are important cost / benefit considerations to be taken account of here, but even setting these aside we do not believe it is either necessary or desirable for going concern to be established to the level of 'near certainty' for the preparation of legal entity annual accounts. Moreover the costs involved in a fund-raising situation are not merely limited to those of completing the exercise itself. The funding assumed in the model must be available and therefore there are also arrangement and commitment fees to take into account. Furthermore, careful consideration would need to be given as to the implications for the auditors ie, what level of assurance would be desirable/practicable for such information.

7. Does the company assess future cash flows and liquidity on a regular basis throughout the year? If so, how regularly is this done and is the information used any different to that used in the annual and half-yearly assessment for the purpose of preparing financial statements?

34. Again, the regularity of the exercise will depend upon the circumstances of the company involved, and it is therefore difficult to generalise in this regard. In some organisations cash-flow forecasting is a near continuous exercise while for others it is appropriate to update this information monthly or quarterly. For those entities with very frequent cash-flow forecasting it is quite likely that the information will be in a different format to that used in the going concern assessment with the primary difference being the time period considered.

8. To what extent and how do directors assess the viability of a company over the course of its natural business cycle?

35. We do not agree that the term 'natural business cycle' is a useful concept for the purposes of considering going concern risk. Companies do generally look out over the longer term both in assessing strategic opportunities and threats and in making note disclosures. But shifting the accounts basis to this longer time period would not be appropriate because in many, if not most businesses, visibility of cash-flows with adequate certainty for forecasting purposes is difficult beyond a 12 month horizon. It is worth noting that the current requirement in the UK is for going concern to be assessed for a period of 12 months from the date of approval of the accounts. Under both International Financial Reporting Standards and International Standards on Auditing the period is stated as commencing from the balance sheet date with the result that by the time the accounts are released the entity is already some way into the assessment window. We believe that this approach is deficient and suggest that perhaps the Inquiry may wish to consider making a representation to the relevant international bodies to suggest a revision such that the period is commenced from the date of approval.

9. The current model of disclosure identifies three categories of company. What sort of behaviours does this model drive? Is there a different model that might be useful? Would more guidance on the application of the current model be helpful?

36. The current model of disclosure is a good start and has the advantage of being simple and relatively nuanced. However, we have suggested in paragraph 17 that it would be beneficial to supplement it with additional disclosure of factors affecting going concern or liquidity risk and the sensitivity to these factors. If this suggestion was to be adopted then it would reinforce the discipline instilled by the current model and provide useful supplementary detail to assist readers to develop a more thorough understanding of the risk factors.

10. In your experience, what issues have resulted in a heightened focus on the assessment of going concern? What was the nature of the risks that gave rise to these circumstances? Had these risks been identified in advance, and if so, how?

37. One factor commonly present in situations of illiquidity is the inadequacy or withdrawal of sources of financing. For this reason we believe that it is essential that the financial statements contain detailed disclosure of funding lines, their maturity dates and interest arrangements and accordingly this information is provided under both UK GAAP and IFRS. Indeed IFRS 7 *Financial Instruments: Disclosures* goes further than this by also requiring the disclosure of key sensitivities such that users can more easily gauge the effect of, say, a change in interest rates. Pension liabilities can be an area of material importance to solvency and again these are the subject of extensive disclosures.

38. However, regardless of the quality or extent of disclosures it is always possible that events occur outside of the foreseen range of possibilities which tip an entity into insolvency. For example, the possibility that the wholesale markets might suddenly freeze, as they did at the height of the financial crisis, was wholly unexpected. Another pertinent example would be interest rates. At present these are very low, but it is possible that base rates could return to levels such as 8-10% (or even15+%), which have been experienced historically. This is a development that would be likely to affect nearly all companies, yet few would describe it as a risk which was sensitised in their disclosures as it would have the potential to be seen as boilerplate. The disclosure of perceived low probability and high impact issues such as this is an important consideration and indeed it may be that such risks are better disclosed (where material) as part of the longer term business model reporting rather than being included in the going concern disclosure.

39. Ultimately, it is not possible to predict the unpredictable and indeed some failures are due to issues such as fraud that may not have been readily detectable before the event. At least however were brief disclosures of key going concern or liquidity risks to be made as we have suggested in paragraph 17 then users would be able to make a more informed assessment of those that are more foreseeable.

11. The auditor's approach to going concern and liquidity risk

How does the auditor approach the assessment of going concern and liquidity risk?

40. The auditor's approach to going concern is driven by the requirements in the standard ISA (UK and Ireland) 570 *Going Concern*, supported by the application guidance in the standard, and is well established in practice. The APB's Bulletin 2008/10 *Going concern issues during the current economic conditions* provided some helpful additional guidance on matters for auditors to consider. We have not picked up any evidence that the existing standard, supplemented by helpful guidance from the FRC/APB, is deficient or in need of expansion given existing auditor responsibilities. However, as mentioned in paragraph 17 regarding possible changes in the reporting arrangements, the implications for auditors will need to be considered in relation to such a proposal. It is important to bear in mind that the auditor's responsibility is to evaluate management's assessment of going concern. Therefore at a detailed level, the approach the auditor adopts will depend on the nature of management's assessment, including for example, the degree of formality in forecasting etc.

To what extent does this involve the testing of the company's processes and what other work is carried out?

41. Because the auditor's responsibility is to evaluate management's going concern assessment, it inevitably does include some testing of the company's processes – specifically the company's forecasting and budgeting processes, including review of the key estimates and assumptions used in those forecasts and budgets. This includes ensuring that there are reasonable downside sensitivities included in management's assessment, and requires auditors to apply their professional scepticism. The extent of review depends on the company's financial position. Where there is clearly significant headroom in terms of both cash requirements and any loan covenant compliance, this review should not need to be extensive. Another key area of work for the auditor is establishing the availability of financing, particularly if loans are due for renewal and/or there are doubts about covenant compliance. This includes understanding the company's relationship with those providing finance and the status of any ongoing discussions regarding renewal of facilities, and may involve direct participation in discussions with bankers etc.

Is there any specific reporting on the work done by the auditor on going concern and liquidity risk to Audit Committees?

42. Where there are going concern risks, experience of auditors has usually been that there has been evidence of extensive discussion with the audit committee, although this might not have been transparent to users. The auditor will typically be involved in reviewing audit committee papers produced by management, and will then comment on the results of their audit work both in their reports to audit committees and in discussions with the audit committee. An area of particular focus in those discussions, where there are going concern uncertainties, is the adequacy of the disclosure in the financial statements, and in particular the need to refer specifically to material uncertainty and significant doubt. As noted in the response to question 12 below, it would be very helpful for the FRC to require directors to use those precise words, as they are used by the auditor in their emphasis of matter paragraph in the audit report. As stated in paragraph 21, ICAEW supports emphasising of the role of the audit committee and sees merit in the proposal in the FRC's Effective Company Stewardship paper for greater transparency regarding the key issues that are considered in the communication between external auditors and audit committees but consider that it is appropriate for such disclosure to be made in an audit committee report rather than the external audit report.

Does the assessment of going concern involve different processes in certain industry sectors?

43. The going concern assessment involves different processes for banks and other financial institutions. Banks operate on the basis that their assets generally have longer maturities than their liabilities, and therefore the going concern analysis here is rather different. Firms with banks and other financial institutions in their client base are likely to have issued specific guidance in this area. More generally, an understanding of the relevant industry is important to any auditor's assessment of going concern, to be able to assess how the economic environment affects the client, its customers and suppliers. The issues may be different for retailers, IT service provider, house builders etc.

Are there different processes used where there is overseas reporting in addition to UK reporting?

44. There is no significant difference in the processes where there is overseas reporting. The period to be considered in the UK, ie 12 months from the date of approval of the financial statements, is longer than in most other countries. This can result in some practical issues where, for example, a UK statutory entity depends on financial support from an overseas parent, because the going concern period considered at the time of finalising the parent's financial statements is likely to end some time before the period to be considered for the UK entity, requiring some update procedures to be performed on the overseas parent. But where there is good co-operation between the overseas group auditor and the UK auditor, these issues can be addressed relatively easily.

Feedback on the Guidance for Directors of UK Companies in respect of going concern and liquidity risk

12. Do you believe that amendments to the Guidance for Directors of UK Companies in respect of going concern and liquidity risk would be helpful? For example:

- **Guidance for directors on disclosures does not specify the language to be used, whereas auditors use more standardised wording. Is this helpful?**
- **Is there a need for a clear boundary between the three types of company?**

45. The existing FRC guidance is good and has already improved practice significantly. In our view therefore a major overhaul of the existing framework is unnecessary as the desired improvements can be effectively achieved through simple, targeted fine-tuning of the guidance. As one specific example, and in addition to our suggestion in paragraph 17, it would help close the expectation gap if the FRC were to explain clearly that the going concern test for accounting purposes is lower (and appropriately so) than in relation to the statement on working capital under the Listing Rules. Furthermore, paragraph 80 of the guidance states that ‘it is helpful … if all of these disclosures are brought together in a single place’. This is too tentative; it is important that the relevant information is arranged coherently together in an accessible way and therefore further thought should be given to how this paragraph can be made more prominent. The Council may also wish to consider making more explicit the fact that the document is intended as guidance and is therefore not mandatory; small companies in particular may be uncertain on this point and it would be useful for it to be articulated more clearly. Finally, it would be very helpful for the FRC to make unequivocal the requirement that directors use the words material uncertainty and significant doubt where that is the case, as these are the words used by auditors in their emphasis of matter paragraphs in the audit report.

13. Are there any other views that you would like the Panel of Inquiry to take into account?

46. Please see the ‘major points’ we have set out in paragraphs 5 to 14 above.

47. We would also add that the FRC, through the current Inquiry, is seeking a UK solution to this issue. It should be noted that this is an international issue and that there are potentially disadvantages to companies registered in this country should the UK adopt a particularly onerous regime, although in those areas addressed by international standards or subject to current scrutiny at a European level, the scope for unilateral action is limited. Furthermore, we do feel that at present the well developed and proportionate narrative reporting requirements in the UK actually amount to a source of national competitive advantage for our capital markets, it would be as well were any changes to the framework arising from the Inquiry to augment this.

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