9 January 2012

Our ref: ICAEW Rep 03/12

The Sharman Secretariat
c/o The Financial Reporting Council
Aldwych House
71-91 Aldwych
London WC2B 4HN

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 preliminary report and recommendations of the panel of inquiry.

We welcome the debate the Panel has initiated and the broader dialogue it is instigating on the requirements for reporting on risks, liquidity and funding. We support the Panel's initiative to address these areas and find much to welcome in the direction of the preliminary report. However, we have a number of concerns with the Panel's preliminary conclusions and these are explained further in the response that follows. In particular we feel that before any final decisions are taken it is essential that the detail of proposed changes is exposed to review by interested parties. It is at this stage, through a review of detailed illustrative examples, that the implications can properly be assessed and adjustments made to the proposals. We stand ready to assist the FRC in its work in this area.

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

Yours sincerely

Robert Hodgkinson
Executive Director, Technical

T +44 (0) 20 7920 8492
E robert.hodgkinson@icaew.com

ICAEW REPRESENTATION

GOING CONCERN AND LIQUIDITY RISKS: LESSONS FOR COMPANIES AND AUDITORS

Memorandum of comment submitted in December 2011 by ICAEW, in response to the preliminary report and recommendations of the panel of inquiry *Going Concern and Liquidity Risks: Lessons for companies and auditors* published in November 2011.

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INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the preliminary report and recommendations of the panel of inquiry (the Panel) *Going Concern and Liquidity Risks: Lessons for companies and auditors* published on 3 November 2011. A copy of which 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

ICAEW welcomes the work of the Panel in scrutinising the process by which going concern is assessed and reported upon by management

5. We welcome the debate the Panel has initiated and the broader dialogue it is instigating on the requirements for reporting on risks, liquidity and funding. We believe that at source this reflects an increased demand from shareholders and a consequent focus by companies on improving risk management and risk reporting in general and on the issues of going concern and liquidity in particular. We support the Panel's initiative to address these issues and find much to welcome in the direction of the preliminary report. However, we have a number of concerns with the Panel's preliminary conclusions and these are explained further below. Significantly we feel that before any final decisions are taken it is essential that the detail of proposed changes is exposed to review by constituents. It is at this stage, when the details can be fully examined through illustrative examples, that the implications can properly be assessed and adjustments made to the proposals. We stand ready to assist the FRC in its work in this area.

The basic accounts level assesement of going concern and the 'three bucket' reporting model for auditors

6. We believe that the binary assessment of whether or not it is appropriate to prepare the accounts on a going concern basis, and the simple disclosure of that conclusion, achieves what it needs to. Change in this area should therefore be considered carefully. Consequently, while we agree with many of the Panel's findings, and in paragraph 9 below make some suggestions as to how the going concern assessment process and its accompanying

disclosures could be enhanced for main-market listed companies, we believe that change might not be necessary to the underlying accounting standards, to company law requirements or to *Going Concern and Liquidity Risk: Guidance for Directors of UK Companies 2009* (the FRC guidance) itself. In achieving the Panel's objectives we do not believe it is necessary to make fundamental changes to the current going concern regime which is used as the basis for accounts preparation by 2.4 million, predominantly small, companies in the UK. We urge the Panel to expose its final conclusions for review by constituents so that their scope and applicability can be properly assessed in the context of the final requirements.

7. Similarly we believe that any change to the current 'three bucket' model for auditor reporting needs to be carefully considered. The ability of auditors to, as a matter of judgment, include an emphasis of matter paragraph within their report is a central tenet of the current regime and is an effective mechanism for ensuring appropriate disclosure where concerns exist around solvency or liquidity. Furthermore this model is the accepted international position under 'clarity ISAs' which the EC is currently seeking to adopt. UK departure from this agreed position would be most undesirable.

8. We note that where changes to UK financial reporting or auditing requirements are mooted the requisite bodies to lead these are the Accounting Standards Board and the Auditing Practices Board. We trust that these bodies will be appropriately involved in any developments in these areas.

Requirements for disclosures of going concern risks by listed companies could be enhanced

9. Where improvements could be made is in the business model / risk disclosure requirements for main-market listed companies. These could usefully be refocused to cover key risks to the entity's liquidity or solvency in the short term. These disclosures could communicate:
   - the specific solvency or liquidity risk factors (if any) that might cause the company to fail;
   - how management has gone about assessing these risks, what they have concluded; and
   - the sensitivity of the company to each of these risks, ie, the extent to which the situation at the date the accounts were approved would have to change before the risk became critical.

10. We appreciate that there may be some overlap here between the key risks currently disclosed and those specifically relating to going concern. The preliminary report is a little unclear in this area and we feel may confuse the two. In the context of going concern, it is important to recognise the significance of the time period over which liquidity and solvency risks are assessed. This time dimension is appropriately addressed in section 2 of the FRC guidance and would not benefit from change.

11. We welcome the principle in paragraph 155 of the preliminary report that 'disclosure should be about the issues and risks identified in the process rather than primarily about the process' itself. In instigating change to disclosure requirements there is a danger of introducing valueless 'boiler plate' narrative. Provisions should be framed in terms that enable entities to craft bespoke company specific risk disclosures rather than as requirements to reproduce bland process statements. We therefore applaud the Panel's initial direction in this regard and trust that such principles will form a central element of its final recommendations. To ensure that this objective is met it may be of value for the FRC to consult on any illustrative wording before it is finalised.

Further consultation essential before any changes to UK regime are finalised

12. If the Panel does resolve to make changes to the UK regime it is imperative that constituents have the opportunity to review and comment upon the revised requirements before they are enacted. Consequently we feel that the next stage in the process, before any final decisions are taken, should be the issuance for consultation of a detailed exposure draft including full illustrative material. It is only at this stage, once all of the details are set out together with the

scope and applicability of the proposals, that the full implications can be properly assessed. In developing the 2009 FRC guidance there were a number of iterations in the testing and refining of the final text, we would anticipate a similar process in this instance.

A strong UK consensus will be essential to achieving international buy-in

13. As the preliminary report acknowledges both accounting and auditing standards for listed companies are set at the international level. Although a recommendation is made that these be aligned with the Panel's final recommendations, for this to be achieved it will be necessary to build an international consensus behind the report's findings. This is likely to prove very difficult unless UK constituents are firmly behind these conclusions and therefore we urge the Panel, before publishing its final recommendations, to ensure that key groups are aligned with its direction of travel. As regards auditing standards the IAASB (International Auditing and Assurance Standards Board) currently has a wide-ranging project underway on all aspects of auditor reporting – including going concern. Any debates on changes to these disclosures therefore are best conducted in an international forum – at the least to ensure that UK practice does not diverge from international standards. Indeed, as the market for capital operates today on a global basis it is important that a robust and proportionate UK regulatory regime acts as a source of competitive advantage rather than disadvantage. The preliminary report has much of value to add in this area, but it is important that these international dimensions are not neglected.

The importance of consistency

14. It is important that the Panel addresses any potential ambiguity or inconsistency in implementing its recommendations. Indeed part of its task lies in drawing a clearer path through the current requirements. In paragraphs 24-30 below we suggest some areas that may benefit from further attention.

Inadequate time for consultation and finalisation of the recommendations

15. Given the importance of the issues being consulted on and the potentially far reaching consequences of the Panel's conclusions we are disappointed that a period of only two months (including the Christmas and new year holidays) has been given for consultation. ICAEW works in the public interest to ensure that its responses to consultations such as this are rigorously constructed and well balanced and as such follows a certain due process in forming and articulating its views. On this occasion, not only have we established a specific working party to review our responses to the Panel, but in addition a number of ICAEW committees have also been involved in contributing to this process. We have been calling for some time for consultative bodies to favour the widely supported norm of a minimum three month consultation period and we hope that at the next stage of this process the FRC will heed these calls and build into its timetable adequate time for consultation.

16. Not only is the consultation timetable unduly compressed, we are also concerned that by planning to issue its final recommendations in February 2012 the Panel is not giving adequate time to properly consider consultation responses and develop and test its recommendations. As the review draws to a close we urge the Panel to ensure that adequate time is allowed to reach appropriate conclusions.

RESPONSES TO SPECIFIC QUESTIONS AND RECOMMENDATIONS

Question 1:
Do you agree with the Panel's overall conclusion that the going concern process and disclosures should be designed to encourage appropriate business behaviours?

17. We agree that going concern assessment processes and disclosures should be designed to encourage appropriate business behaviours. Indeed, in our view, every part of the UK framework comprising company law, accounting standards, codes and guidance and listing rules should be designed and operate positively for this purpose. Nevertheless, while it is desirable to remain mindful of encouraging positive behaviour in drafting regulation it is quite another thing to attempt to enforce such behaviour through the introduction of prescriptive requirements. We suggest that this is unlikely to be effective and may bring with it other damaging side effects.

18. Therefore, it will be important to ensure that in encouraging such appropriate behaviours the design of going concern processes and disclosures is proportionate and balanced. Balance is important to ensure that the going concern process and resultant disclosures do not cause companies or others to send inappropriate messages of alarm to a multitude of stakeholders (banks, suppliers of credit, investors, employees, etc.), and that they do not constrain disclosure where more could usefully be said. After all, taking risk is an inherent part of business; indeed without risk there would be no activity and no profit. In a capitalist system, firms do sometimes fail but ultimately in an efficient market new businesses that may succeed are established in their place. The overall corporate governance system cannot prevent firm failure, nor should it seek to do so. It is therefore important to focus on what can and should be done, managing investor expectations such that they are not being led to believe that any system could be established which would achieve the impossible, ie, that their capital would not be at risk.

Question 2:
Do you support each of the five recommendations set out in Chapter 1? Please give your reasons for agreeing or disagreeing with each of the recommendations.

Recommendation 1
The Panel recommends that the FRC should seek to establish protocols with BIS and with other regulatory authorities that will enable the FRC to take a more systematic approach to learning lessons relevant to the scope of its functions when significant companies fail, through assessing the underlying circumstances. This might be achieved through a combination of approaches, including analysis of Insolvency Practitioner reports and regulatory authorities and others appointed by them to investigate or inquire into such circumstances.

19. Yes; we believe it is important that from incidents of this kind relevant lessons can be drawn where possible and we therefore support the work of the Panel in striving to improve this. We agree that much can be gained from better coordination between the bodies; without adequate coordination there is a risk both of overlap and of some matters falling between them. We particularly appreciate the efforts of the Accountancy & Actuarial Discipline Board (AADB), of BIS and of other regulatory bodies in investigating instances of corporate failure.

20. In our recent response to BIS consultation *Proposals to reform the FRC* (ICAEW 125/11) we agreed with the concept of the FRC developing a mechanism to enable it to undertake supervisory inquiries into matters of concern. However the FRC's role here in the regulation of companies, should not be confused with the regulation of markets and we are concerned by indications that the FRC appears to want to develop such a role as a market regulator, thereby appropriating some of the powers which in the US are held by the SEC. We are also concerned about the risks of concentration of power and executive responsibility within one organisation. It is important that effective checks and balances be put in place

21. Furthermore, there could be general concern and suspicion that such powers might be used for a fishing expedition, and therefore the specific scope and criteria for each inquiry should be carefully set out and justified. We suggest each inquiry should be approved by BIS on a case by case basis, and that recognised supervisory bodies should be consulted to ensure a joined-up approach and avoidance of duplicated effort or confusion of roles/responsibilities/activities. The mechanism and time-frame need to be made clear.

22. It should also be noted that there may well be pressure for appropriate regulatory response whenever prominent issues, such as a high profile corporate failure, arise and indeed this has proven to be a recurrent feature in the regulatory environment. Consequently, while we favour a more established protocol for information gathering and assessment and better coordination between the various bodies, we hope that the existence of such a system does not develop into an imperative for regulatory reaction. In a capitalist system corporate failures do occur from time to time and not every instance offers significant lessons, even in some of those cases with a high media profile.

23. The FRC should also appreciate that corporate failures may involve criminal and civil legal actions which may take precedence over any investigation that the FRC may wish to institute, and thus the FRC may not, even with extended powers and protocols, be able to proceed as quickly or in the way it wishes because of such constraints. The FRC has hinted in its paper on its own restructuring that it may seek further legal powers and we wonder whether this would for example extend to the ability to institute directors' disqualification proceedings or to implementing a ‘no liability’ regime for those who step forward to provide evidence. We also wish to see how this and the FRC's wider ability to investigate would operate in the context of the powers of a receiver or administrator and general insolvency law in a corporate failure. Ultimately the proposals in this area would benefit from further elaboration, taking into account the results of the FRC’s proposed reforms and how these may dovetail with the existing investigative processes of other agencies.

Recommendation 2
The Panel recommends that:

- a) **The FRC should seek to harmonise, and to clarify, the common purpose of the going concern assessment and disclosure process in the Code and related guidance for directors and auditors) and in FRS 18 – and, in doing so, should reconsider whether the language of the provision of the Code, to the effect that the directors should state that the entity IS a going concern, is too definitive;**
- b) **The FRC should engage with the UKLA to seek to maintain the existing congruence of the Code with Listing Rule 9.8.6 (3)R, in light of these changes.**
- c) **The FRC should engage with the IASB to seek amendments to IAS 1 to accord with the resulting position in the Code and FRS 18.**

24. We agree with the conclusion of the Panel that discrete and differing going concern requirements between different regulatory vehicles could be a significant contributing factor to the ‘expectation gap’. However, we feel that this difference is more in perception than in practical effect and therefore the Panel may wish to consider carefully where efforts should be focused in attempting to address it. We do not feel that change is necessary either to the basic going concern model in the accounting standards or to the requirements of company law.

25. Paragraph 6 of the preliminary report concludes that there are two apparently opposing thresholds for going concern between the accounting standards and the Code. The second bullet of paragraph 6 suggests that the Code requirements may lead users to read, in certain circumstances, the going concern statement as ‘a guarantee that the entity will not collapse or fail’. However, both the Code and listing rule 9.8.6 do currently reference the FRC guidance, which refers in several places to Directors’ having a ‘reasonable expectation that the company will be able to continue in operational existence’. This is not a guarantee of solvency and

therefore in practice, if not in perception, we feel that the Code statement is already less definitive than suggested in the preliminary report.

26. We understand the Panel's sentiment that a single statement, that an entity is a going concern, is too definitive, but essentially two issues are at stake here and it may be useful to separate them. IAS 1 *Presentation of financial statements* and *FRS 18 Accounting policies* both require management to make a binary assessment of an entity's ability to continue as a going concern. If the conclusion from this is 'no', then the accounts may no longer be prepared on a going concern basis and that fact must be disclosed together with the reasons for reaching that decision. This element of the requirements is not problematic and we do not believe that there is any reason for change here.

27. The second issue however relates to business model / risk disclosures and it is here perhaps that the further attention of the Panel would best be directed. IAS 1 and FRS 18 both require additional narrative disclosures where the directors are aware of 'material uncertainties' that cast significant doubt upon an entity's ability to continue as a going concern. Code provision C.1.3 and listing rule 9.8.6 (3) requires disclosure of 'supporting assumptions or qualifications as necessary' underlying the directors' going concern assessment. Section 417 of the Companies Act 2006 then requires all quoted companies to disclose in their business review 'a description of the principal risks and uncertainties facing the company'. Not only do these requirements overlap, but they may also be better directed to ensure the capture of key risks to the entity's liquidity or solvency in the short term (while still ensuring that any material uncertainties are captured). It is important that the disclosure of any material uncertainties, clearly indicated as such, is maintained, but a coordinated effort to appropriately refocus business model / risk disclosures could add much value in this area. In our paragraph 32 below we suggest how this might be achieved.

28. In our view it is important that the issues raised in this section are considered and synthesized first by the Panel and the FRC before any resultant regulatory change is considered. Once the Panel / FRC is in a position to move forward it may then be easiest and most appropriate to implement its recommendations through a change to the Code / listing rules rather than through any amendment to company law. Company law already contains adequate provisions regarding the disclosure of key risks.

29. As part of this consideration the question may arise as to the juxtaposition of the 'material uncertainty' disclosure requirement in the accounting standards and more general narrative business model / risk disclosures. Where such uncertainties exist it is imperative that they be disclosed in the accounts and we see no need for change to the current model within the accounting standards themselves. Nevertheless, we strongly support clarity of disclosure and believe it is important to achieve consistency and cohesion between all elements of the annual report and accounts as far as possible, bearing in mind that all information necessary to giving a 'true and fair view' must be included in the audited accounts. It may be that the Code / listing rules are the best mechanism for effecting the required improvements to disclosure.

30. Finally we note that there does appear to be inconsistency with paragraphs 124 and 125 of ESMA's guidance on working capital statements within prospectuses *ESMA Update of the CESR Recommendations*. Paragraph 124 requires that there is 'very little risk that the basis of such a statement is subsequently called into question', while the last bullet of paragraph 125 would require an 'assessment of whether there is sufficient margin or headroom to cover a reasonable worst case scenario'. Although this very high bar is restricted to the context of prospectuses, this is not necessarily made clear from the drafting. Indeed paragraph 124 seems to imply an unwarranted relationship between this and considerations underpinning the preparation of the annual report; 'the procedures adopted by issuers in making a statement are expected to be very similar to those adopted by issuers in concluding that the annual accounts should be drawn up on a going concern basis'. Consequently the ESMA guidance may well itself contribute significantly to the expectation gap. While we do not believe any change is necessary to the going concern assessment for either purpose, the Panel may wish to

consider whether any steps could be taken to ensure awareness as to the different levels of 'certainty' underlying prospectus and annual report disclosures. Through this the expectation gap may be reduced.

Recommendation 3

The Panel recommends that the FRC should review the Guidance for Directors to ensure that the going concern assessment:

- **reflects the right focus on solvency risks, not only on liquidity risks, whatever the business. In relation to solvency risks, this should include identifying risks to the entity's business model or capital adequacy that could threaten its survival, over a period that has regard to the likely evolution of those risks given the current position in the economic cycle and the dynamics of its own business cycles;**
- **is more qualitative and longer term in outlook in relation to solvency risk than in relation to liquidity risk; and**
- **includes stress tests both in relation to solvency and liquidity risks that are undertaken with an appropriately prudent mindset. Special consideration should be given to the impact of risks that could cause significant damage to the community and environment, bearing in mind the directors' responsibilities under the Companies Act 2006.**

31. We welcome the Panel's re-examination of the ways in which going concern is assessed and reported upon and assuming these are limited to main-market listed companies we agree with its preliminary conclusions. The financial crisis and related corporate failures of recent years have highlighted the importance of risk management and of transparent, relevant and robust risk disclosures. Going concern risk is an integral element of this process. ICAEW's recent publication *Reporting Business Risks: Meeting expectations* (the latest in its Information for Better Markets thought leadership series) explores these issues in more detail and makes a series of recommendations for better risk reporting.

32. The preliminary report raises the prospect of a fundamental realignment of the going concern assessment and reporting process and the Panel's recommendations would move us to a system where a more balanced consideration of an entity's business model would be required. We do not agree that a radical overhaul of the regime is merited for UK private companies, but for those entities that, by virtue of being listed, have a higher degree of shareholder accountability we support this direction of travel as it promises to offer better information to users. Indeed in our initial response to the Panel (ICAEW REP 66/11) we suggested that for main-market listed companies going concern disclosures could usefully be refocused to cover key risks to the entity's liquidity or solvency in the short term. These disclosures could communicate:

    - the specific solvency 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;
    - the sensitivity of the company to each of these risks, ie, the extent to which the situation at the date the accounts were approved would have to change before the risk became critical.

33. 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. Nevertheless, before any final decisions are taken it is essential that a detailed exposure draft including full illustrative material is issued for consultation.

34. However, while we believe that the Code requirements could valuably be strengthened we do not believe that it is necessary to extend these modifications into the FRC guidance for UK companies more widely. Through its 2009 guidance the FRC has already made a significant

contribution to codifying and enhancing going concern assessment and disclosure. This has undoubtedly achieved much success in raising standards and remains fully fit for purpose for those majority of companies that do not have a higher degree of shareholder accountability. Where the guidance references the Code then these elements would naturally need to updated to reflect any revisions but beyond this we do not believe change is merited.

35. Commenting on paragraphs 101 to 121 of the preliminary report; we agree that in assessing going concern the directors should be mindful of risks to both liquidity and solvency. Ultimately if there is a risk of business failure in the immediate future, whether that comes from access to funding or from wider business problems, investors will be very interested in understanding it in more detail.

36. However, we are concerned that in making recommendation 3 the Panel has perhaps blurred the line between the binary assessment of going concern for accounts purposes and the judgments underlying the disclosure of an entity's business model and associated risks. Accounting standards do require the Directors in making their going concern assessment to 'take into account all available information about the future' (FRS 18 uses the term 'foreseeable future'), but it does not necessarily follow that all longer term risk factors will be critical or even immediately relevant to going concern. An important distinction could be drawn here between risks to going concern and risk more generally and in drawing that distinction the time element is very important. Given sufficient time most significant risks could possibly tip a company into insolvency by eroding profits or absorbing liquidity and indeed few corporate entities have been seen to exist in perpetuity. It may be very difficult to conclude with certainty that a key product line will remain profitable over a given time period or that a reliable replacement could be found in time. This is the nature of risk and just because the future is uncertain it does not mean that a particular company may not be a going concern.

37. In particular, we do not agree that the 'economic cycle' or 'natural business cycle' are useful concepts for the purposes of considering going concern risk. Not only are these likely to extend for a period beyond the 12 months over which in the absence of longer term factors going concern is normally assessed, but it may be difficult and very subjective in practice to determine the duration of such a cycle and the entity's current position within it. In the case of the economic cycle recent empirical evidence would tell us that even leading economists are unlikely to be able to make predictions regarding the future performance of the economy with any degree of certainty.

38. Indeed any change to the time parameters over which going concern is currently assessed, clearly articulated in section two of the FRC guidance, is likely to be problematic. Both Basel and Solvency II regimes look at the probability of risks crystallising over a 12 month timeframe. It is not unusual for entities to hold a buffer over regulatory solvency requirements in case of a 1 in 10 year event happening in that 12 month period. The probability of that buffer being exceeded when assessed over a longer period is therefore quite high and would arguably require disclosure. There will also be incidences of credit facilities expiring and debts requiring refinancing for many businesses when looking beyond a 12 month horizon and so presumably uncertainties surrounding these would require disclosure too.

39. Certain companies or industries may be exposed to risks that could lead to significant damage to the environment or community. Accounts disclosures are intended to demonstrate how management has discharged its fiduciary duty to investors. To the extent that other regulatory objectives are sought it is likely to be most efficient for these to be met outside the annual report. However, some environmental or social risks may be of such severity or immediacy as to threaten going concern and where this is the case these should certainly be disclosed. Indeed in protecting the interests of shareholders (but not as a direct or separate duty in relation to, eg, the environment) section 172 of the Companies Act 2006 requires directors to be mindful of such risks. These may manifest themselves in different ways: acting in a certain way may cause a company to lose its licence to operate; there may be direct and fundamental

liability from environmental or social damage; and reputational risk may be so extreme as to threaten going concern. In all of these cases disclosure may be merited.

Recommendation 4

The Panel recommends that, in taking forward its work on reporting under ECS, the FRC should move away from a model where disclosures about going concern risks are only highlighted when there are significant doubts about the entity's survival, to one which integrates going concern reporting with the ECS proposals through seeking to ensure that:

a) the discussion of strategy and principal risks always includes, in the context of that discussion, the directors' going concern statement and how they arrived at it; and

40. We welcome the conclusions of the preliminary report in this area. In particular we support the assertion in paragraph 135 that process descriptions 'can rapidly descend into the generic and boilerplate' – in our experience this is certainly the case. We also agree with paragraph 145 that 'current requirements present barriers to desired behaviours'. A default position of no disclosure, as paragraph 145 concludes, could incline directors not to offer additional information as this may send negative signals. The experience then of companies suddenly deteriorating from a 'green signal' position to corporate failure could fuel the expectation gap. We support the Panel's conviction that action is necessary to address these issues. We urge a little caution, however, with the recommended resolution in paragraph 147. We agree that reporting on how the directors 'arrived at the going concern statement' could provide useful information to users, but special care does seem to be merited here to ensure that this does not become the kind of process description that paragraph 135 warns against.

41. We certainly do not wish to see duplication in disclosure and in most places would envisage that the key risks to going concern, and perhaps – if clearly referenced - any material uncertainty disclosures, would dovetail as far as possible with strategic/principal risk disclosures as set out in the *Effective Company Stewardship* paper. Any disclosures necessary to showing a true and fair view will still need to be included within the audited accounts but appropriate cross-referencing could minimise duplication. And although greater alignment is desirable the two are not entirely interchangeable as seems to be implied by the preliminary report. Many longer term business risks could eventually threaten solvency as explained in paragraph 35 above, but their presence is not necessarily relevant to reviewing going concern over the assessment period.

b) the audit committee report illustrates the effectiveness of the process undertaken by the directors to evaluate going concern by:

- **confirming that a robust risk assessment has been made;**
- **providing an explanation of the material risks to going concern considered and addressed; and**
- **identifying any that they have not been able to resolve;**

and recommends that the FRC should amend standards and guidance for directors and auditors accordingly when the ECS proposals are finalised.

42. We believe that the audit committee should confirm in their report that a robust going concern assessment has been undertaken by the directors. However, the reference to 'illustrate the process' and the specific points referred to in the recommendation imply that it is recommended that audit committee report should repeat details of the going concern assessment described in the annual report by the directors. We do not believe that is necessary and, indeed, would contradict the FRC's own "Cutting Clutter" agenda.

43. We comment on the recommendation to amend standards and guidance for auditors in our response to recommendation 5 below.

Recommendation 5
The Panel recommends that, as part of its work on auditor reporting arising from the ECS proposals, the APB should:

a) **consider moving UK auditing standards away from the three category model for auditor reporting to a statement in the auditor's report as to whether the auditor is satisfied that, having considered the directors' going concern assessment process, they have nothing to add to the disclosures made by the directors about the robustness of the process and its outcome; and**
b) **seek to encourage the International Auditing and Assurance Standards Board to accommodate this approach in the International Standards on Auditing.**

44. UK auditing standards are the responsibility of the Auditing Practices Board (APB). The APB is committed to implementing International Standards on Auditing (ISAs) in the UK and ICAEW has been at the forefront of the adoption of ISAs internationally for some years. In the UK, ISAs have been adopted with a limited number of additional requirements relating to UK law and regulations (ISA 'pluses'). A move away from the 'three category' model described in the report, which is in line with the extant ISAs 705 and 706, would require a high standard of justification in line with APB criteria for deviating from ISAs. And because this would represent non-compliance with the requirements of an ISA it could be interpreted as an ISA 'minus'. At present, while there are a few ISA pluses to reflect UK law and regulation, there are no ISA minuses. This helps to maintain international consistency which is one of the main strengths of the ISAs and of the reasons for their adoption by many countries across the world.

45. In any case, we believe that any move away from the current 'three bucket' model needs to be carefully considered. The ability to include an emphasis of matter paragraph where there are matters of 'significant uncertainty' is a useful tool in the auditor's armoury and has frequently been used to good effect in the recent financial crisis. It could therefore be detrimental to remove this option. The preliminary report (paragraph 151) draws a stark distinction between accounts in 'categories 1 and 2'; those with a 'clean' audit opinion and those including an emphasis of matter paragraph. We question the conclusion implicit in this distinction that, in 'category 1' situations where some going concern risk is present, current disclosure practice is necessarily deficient. This may have been a concern prior to the introduction of the new FRC guidance in 2009, but now the guidance illustrates (Appendix 1 examples 1(a), 1(b) and 2) situations where in the absence of an emphasis of matter paragraph adequate disclosure is still successfully achieved. It is important that the progress here be recognised, particularly as it evidences the versatility of the current model.

46. We do recognise that more nuanced disclosure of going concern can be achieved through an enhancement of the business model / risk disclosures that directors of main-market listed companies are required to make (see paragraph 32 above), but we do not believe that change to the audit report is necessary to deliver this. The three bucket model works well in producing descriptive disclosure where this is merited, combined with appropriate disclosure by directors it offers an effective mechanism for communicating going concern risk. As we note in paragraph 12 above, before any further action is taken it is essential that constituents have the opportunity to examine the detail of the proposals through the publication of a series of illustrative examples.

Question 3:
Should the scope of any final recommendations be applicable only to listed companies or also to other entities? If they should be applicable also to other entities, please indicate whether to all or only some types of other companies and entities and whether any adaptations should be made to the recommendations in doing so.

47. We do not believe that a change to company legislation, accounting standards or the FRC guidance is necessary to achieve the Panel's objectives. Enhanced disclosures for main-market listed companies could be enforced through the Code and listing rules.

48. It is important to bear in mind in this that while consistency is important that is not the same thing as uniformity. At present section 417 of the Companies Act has a tiered system for the presentation of the business review; quoted companies deliver the full report, medium and large private companies have a reduced requirement with disclosures being ‘consistent with the size and complexity of the business’, while small companies are not required to produce a business review at all. Any changes introduced as a result of the Panel’s review must be proportionate. BIS is currently working to reduce ‘red tape’ for small and medium businesses and therefore any additional regulation in this area would be most unwelcome.

Question 4:
In relation to banks, do you have any comments on:

- **The suggestion that there should be a separate disclosure regime for banks and their auditors in relation to the going concern assessment (see paragraphs 232 to 234)?**
- **The merits of a separate financial reporting and auditing regime for banks (see paragraphs 235 to 236)?**

49. In general we do not believe that a separate financial reporting or auditing regime is necessary for banks. Transparency is enhanced where financial reporting regimes are common across the capital markets; by framing standards in terms of general principles rather than prescriptive rules individual companies can make decisions appropriate to their circumstances. By setting requirements at the capital market level these can be developed away from the influence of specific industries and by reference to broadly applicable principles. Moreover, solvency and liquidity risk factors are not restricted to the banking industry. Liquidity positions can rapidly sour in many businesses for a variety of reasons, changes in the external environment can quickly threaten solvency.

50. We agree, however, that some factors are more concentrated in the banking sector, for example liquidity pressures have been seen to escalate more rapidly than in other industries in times of crisis. In light of these risks we agree that banks may have special considerations to take into account in making their going concern assessment and in devising the related disclosures. We believe that banks should follow the same underlying going concern regime as other main-market listed companies. However, given that short term liquidity risks are particularly acute in the banking business model it is to be expected that their risk disclosures will address these factors in greater detail than other businesses. It would therefore be useful to provide some additional guidance on how these disclosures may be made and on any additional factors that it may be particularly relevant to consider as part of the assessment. Not only would this perform a useful role in ensuring that investors receive the information they need about the business model, but it may also provide an opportunity to avoid generic, non-relevant disclosures which, in the absence of appropriate guidance, institutions may otherwise feel compelled to provide.

51. Paragraph 227 of the preliminary report considers the importance of secrecy and of whether bank disclosures should be constrained or limited in time of crisis. We believe that transparent financial reporting is an essential contributing factor to financial stability and are not convinced that supressing transparency is likely to be an effective or desirable solution. However, we do appreciate the unique circumstances in this regard and believe that the Panel should give this area careful consideration with a view to making a firm recommendation to Ministers.

Question 5:
Do you have any other comments on matters set out in this report?

52. Please see our major points in paragraphs 5 to 16.

E john.boulton@icaew.com

icaew.com