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Governance in brief
Going concern: FRC process major changes

Headlines

The FRC is proposing tougher guidance on going concern:

- "The foreseeable future" becomes more open to interpretation
- New test "a high degree of confidence"
- A call for more tailored company specific disclosures
- Proposals may encourage more conservatism
- Specific supplement for banks developed with input from the Bank of England
- Implementation may prove challenging given the requirement for changes to processes and board assurance
- Fast track implementation – proposals apply for periods beginning 1 October 2012

Background

The FRC has issued a consultation paper on implementation of the recommendations made by the Sharman Panel of Inquiry into *Going concern and liquidity risks: lessons for companies and auditors*. Under the proposals the Going Concern and Liquidity Risk: Guidance for Directors of UK Companies 2009 will be replaced by new Guidance on Going Concern 2013, a new Supplement for Banks, and corresponding changes to International Standards on Auditing (UK and Ireland).

The 2009 Guidance was primarily designed to support annual and, where relevant, interim reporting. The draft 2013 Guidance calls for going concern assessment to be integrated within the processes for setting strategy, running the business, and managing risks, including an assessment of the sustainability of the business model in the longer term and the company's adaptability in the face of economic and financial stress.

The proposed effective date for the new Guidance is periods commencing on or after 1 October 2012 with early adoption encouraged, and will apply to half year reporting when finalised. For many companies, this period will already have started and boards may need to make transitional disclosures explaining how their processes have changed during the period to align with the proposals.

Two purposes, two definitions

The draft 2013 Guidance aims to address two different reporting obligations – a financial reporting purpose, and a stewardship purpose.

Financial reporting purpose – appropriateness of the going concern assumption

The FRC is seeking to influence the financial reporting of going concern, but does recognise that this is a matter for the IASB. Accordingly, financial statements will continue to be prepared on a going concern basis unless there is no realistic alternative to placing the company into liquidation or ceasing trading (or management intend to undertake one of those courses of action). This is aligned with the 2009 Guidance.

Stewardship purpose – a new challenging definition of going concern

The draft 2013 Guidance proposes the following new definition of being a going concern:

"A company is judged to be a going concern if, for the foreseeable future, there is a high level of confidence that it will have the necessary liquid resources to meet its liabilities as they fall due and will be able to sustain its business model, strategy and operations and remain solvent, including in the face of reasonably predictable internally or externally-generated shocks."

This poses a number of questions for boards to answer:

- What is a "high level of confidence"?
- How might a board deal with a situation where there is not a "high degree of confidence" but there remain realistic alternatives to liquidation or cessation of trade?
- What does "sustain its business model, strategy and operations" mean in a time of business model transition?

The "foreseeable future" becomes more open to interpretation

In common with the 2009 Guidance, twelve months from date of approval of the financial statements is stated as the minimum period for the assessment. However, the draft Guidance differs from the 2009 Guidance by providing significant additional guidance on the length of the foreseeable future: "the length of the period considered is a matter of judgement and will depend on the nature of the company's business, its business cycles, the life cycles of its assets, the stage of the general economic cycle at the time of the assessment and the quality of the data available to make the assessment".

Examples of the matters that might be considered include:

- strategic or business plans that include profit projections or that compare cash flows to available facilities;
- a longer term qualitative consideration of solvency risks; and
- any stress tests that look out further than twelve months.

A call for more extensive but tailored company specific disclosures

IAS 1 will continue to require disclosure of material uncertainties in the notes to the financial statements.

The Board's "front half" narrative reporting, outside the financial statements, should be tailored to the company's facts and circumstances including:

- confirmation that a robust going concern assessment was undertaken (including issues considered rather than the process), the board's process for assuring themselves as to the assessment, and how the foreseeable future has been interpreted;
- a description of the significant solvency and liquidity risks that have been identified and how significant a threat they pose;
- an explanation as to why the board has concluded that the company is (or is not) a going concern, having regard to those significant risks and how they are being managed; and
- any changes to those significant risks since the last annual or half-yearly report, and whether such changes have arisen from changes in business strategy or other matters.

Determining whether an uncertainty is material or not is a matter of judgement but the guidance presumes that an uncertainty will be considered material if:

- at the time of the board's assessment, there is an uncertainty which might give rise to severe economic or financial distress for which there is no realistic alternative but to (a) take actions outside the normal course of business in order to address it, and (b) the directors are not able to obtain a high level of confidence that those actions will be both available to them and will be highly likely to be effective; or

- it is more likely than not that, within the foreseeable future, the uncertainty may give rise to such economic or financial distress with the consequence that directors may need to take such actions which may not be available or effective.

Specific supplement for banks developed with input from the Bank of England

One of the key topics considered by the Sharman Panel was whether there should be a separate going concern regime for banks. The conclusion was that there should not, but that additional guidance should be provided. A draft Supplement for Banks has been prepared which:

- clarifies the position of liquidity support from central banks;
- provides help in applying the draft Guidance to banks, given their exposure to more intense solvency and liquidity risks and vulnerability to a loss of funding as a result of a loss of confidence; and
- provides guidance on the need for close co-operation between banks, supervisors and their auditors.

Implications for boards:

In our view company directors will wish to give considerable thought to how best to implement the proposals – and we expect most boards to ask the Finance Director, perhaps working with the Audit Committee, to propose the necessary process changes to the Board and/or Audit Committee meeting schedule.

Key areas to consider as part of this review include how the board will:

- Identify and distinguish between solvency risks (the ability to meet liabilities in full) and liquidity risks (the ability to meet liabilities as they fall due).
- Determine the significance of those risks – 'significant' risks are those that could so seriously damage cash flows, performance or future prospects that they would give rise to severe economic or financial distress if they crystallised.
- Consider the likelihood of those risks arising, including sensitivity analysis (flexing variables individually or in combination within a model) and stress testing (a more holistic approach based on business scenarios).
- Consider the availability and likelihood of effectiveness of mitigating actions (whether within or outside the normal course of business) that would be realistically available to avoid or reduce the impact or occurrence of those risks.
- Obtain the necessary assurance at a board level about the robustness of the ongoing processes undertaken and the outcome of those processes – this will likely include monitoring and challenge of management's processes, risk management and internal controls over this area.
- Determine the structure of the review process at the Company: The audit committee (and, if there is one, risk committee) may advise the board, but the responsibility rests with the board.

Boards will also want to arrange for:

- An early review of the related financial and narrative reporting in half year and full year financial statements.
- An early discussion with their auditors.

Directors may also wish to consider responding to the consultation.

More information

A copy of the consultation paper can be obtained from the FRC website. The comment period closes on 28 April 2013.

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