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Need to know
FRC proposals on going concern: Implementing the recommendations of the Sharman Panel

In a nutshell

The FRC is proposing new Guidance on Going Concern 2013, applicable to all UK companies, with a supplement for banks. The new guidance is intended to replace their existing 2009 guidance and sets out two different purposes for going concern assessment – one for establishing whether an entity is a going concern from a stewardship point of view, and the other for determining whether the going concern assumption is appropriate for the purposes of financial reporting.

Financial reporting

- IAS 1 or and the equivalent provisions in FRS 18, FRS 102 and the FRSSE will continue to apply. Financial statements will be prepared on a going concern basis unless there is no realistic alternative to liquidation or ceasing trading.
- New guidance will help determine whether there are material uncertainties which require disclosure.

Stewardship – narrative reporting

- Going concern will be integrated into an entity's risk assessment process with a statement in the strategic report as to whether an entity is a going concern, having considered both solvency and liquidity risks and undertaken stress testing and liquidity analysis.
- There will be a new definition of going concern for this stewardship purpose – "a high level of confidence that [the entity] 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".

For both purposes, the "foreseeable future" period over which going concern is assessed may well be longer than the current minimum twelve months from the date of approval of the financial statements. As with the 2009 guidance, this period will apply under IAS 1, notwithstanding that that standard itself says the period is twelve months from the balance sheet date.

The "foreseeable future" period over which going concern is assessed may well be longer than the current minimum twelve months from the date of approval of the financial statements.

March 2013

Background

In June 2012 the Sharman Panel of Inquiry published its final report into *Going concern and liquidity risks: lessons for companies and auditors*. The FRC is now consulting on implementing the panel's recommendations and will replace the existing *Going Concern and Liquidity Risk: Guidance for Directors of UK Companies 2009* with new *Guidance on Going Concern 2013* and a *Supplement for Banks*.

The 2009 Guidance was primarily designed to support annual and, where relevant, interim reporting. As a result, it focused on assessing whether the going concern basis of accounting was appropriate, whether there were material going concern uncertainties and the drafting of appropriate disclosure. The draft 2013 Guidance goes further, calling for going concern assessment to be:

- integrated within the processes for setting strategy, managing risks and running the business; and
- include 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.

Boards will be expected to obtain assurance over the robustness of the going concern assessment process – in other words, evidence to support the assessment that has been made.

Two purposes, two sets of disclosure

The draft 2013 Guidance sets out an overarching purpose for going concern assessment as 'ensuring that risks that would threaten the company's survival are properly identified and managed, respecting the interests of shareholders, creditors and other stakeholders'.

It then proposes two purposes for going concern reporting with two sets of disclosure requirements:

	Financial reporting	Stewardship
	Information about going concern and liquidity risks needed for the financial statements to give a true and fair view should be disclosed including:	Narrative reporting should provide information to shareholders about the company's economic and financial viability and the Board's stewardship and governance:
Risks and uncertainties	Any material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern. The information about liquidity risks required by IFRS 7.	The significant solvency and liquidity risks that have been identified and: • how significant a threat they pose; and • whether they have changed since the last annual or half-yearly report and, if so, whether those changes arose from changes in business strategy or other factors.
Overall assessment	When the going concern basis is inappropriate, a statement of that fact, together with the basis on which the financial statements have been prepared and the reason why the entity is not regarded as a going concern.	An explanation as to why the Board has concluded that the company is (or is not) a going concern, having regard to the significant solvency and liquidity risks that have been identified and how they are being managed.
Governance		Confirmation that a robust going concern assessment was undertaken including: • specific issues considered; • how the Board obtained assurance about the assessment; and • how the 'foreseeable future' has been determined.

Observation

The draft 2013 Guidance calls for separate disclosures to address each purpose, rather than the 2009 Guidance's call for disclosures to be brought together in one place. Directors may need to consider whether linkage is necessary to avoid confusing readers.

Financial reporting – appropriateness of the going concern basis and existence of material uncertainties

The draft 2013 Guidance does not amend the IAS 1 and FRS 18 definitions of going concern when considering the appropriateness of the going concern basis. It does, however, provide factors for Boards to consider when deciding whether a going concern uncertainty is material or not:

- the magnitude of the potential impact of uncertainties and the likelihood of their occurrence;
- the actions the Board would consider undertaking to avoid or reduce the impact or occurrence of uncertainties;
- whether such actions would realistically be open to the company when needed;
- their likely effectiveness; and
- the potential implications of the uncertainties and any actions for users of the financial statements.

An uncertainty will be presumed to be 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 severe economic or financial distress with the consequence that directors may need to take such actions which may not be available or effective.

Conversely, an uncertainty would not be considered material if the likelihood of the entity not being a going concern is considered remote, even if the assessed impact would be significant.

The additional guidance on determination of the 'foreseeable future' (see below) would also apply to this assessment.

Observation

Many directors will find additional guidance helpful. In order to avoid misleading readers of the annual report it may be necessary to disclose the reasons why uncertainties have been deemed not to be material because of the availability of actions outside the normal course of business.

The IASB have been asked by the IFRIC to take onto their agenda a project to provide similar guidance on material uncertainties within IAS 1 but this work is at an early stage.

Stewardship and narrative reporting – clarifying the definition of going concern

The draft 2013 Guidance provides the following definition for the stewardship purpose:

"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."

The draft 2013 Guidance:

- reiterates that the going concern assessment is a judgement, not a fact, and that a high level of confidence is not the same as an absolute level of confidence. Over the foreseeable future (see below) the ability to predict future events will fall short of certainty;
- requires consideration of both solvency risks (the ability to meet liabilities in full) and liquidity risks (the ability to meet liabilities as they fall due);

• calls for both sensitivity analysis (flexing of variables individually or in combination in models and forecasts) and stress-testing (consideration of whole scenarios rather than just flexing of variables); and

• explains that, whilst an entity that needs to take actions outside the normal course of business is likely to be in significant distress, it may still be judged to be a going concern if the Board judges that those actions are highly likely to be effective in addressing the risks.

As a result, the stewardship going concern assessment will not necessarily produce the same conclusion as the IAS 1 or FRS 18 conclusion as to whether the going concern basis of accounting is appropriate. The effect of these two different reporting obligations will be as follows:

<table>
<tr><th colspan="2">Financial reporting</th><th>Stewardship – narrative reporting</th></tr>
<tr><td rowspan="3">Realistic alternative to liquidation or cessation of trade (and no management intention to liquidate or cease trading).</td><td>Going concern basis of accounting appropriate with no material uncertainties.</td><td rowspan="2">Going concern.</td></tr>
<tr><td rowspan="2">Going concern basis of accounting appropriate with material uncertainties.</td></tr>
<tr><td rowspan="2">Not a going concern.</td></tr>
<tr><td>No realistic alternative and/or management intend to liquidate or cease trading.</td><td>Going concern basis of accounting inappropriate.</td></tr>
</table>

Observation

The introduction of two different tests – being a going concern (for stewardship purpose) and appropriateness of the going concern assumption (for financial reporting) will require that disclosures are carefully drafted, particularly where there is some degree of uncertainty, in order to avoid confusing readers of the annual report.

SEC registrants and affiliates may need to consider how the stewardship reporting interacts with SEC requirements.

The foreseeable future

The draft 2013 Guidance states that the evaluation of solvency and liquidity risks should consider what the Board knows or should reasonably be expected to know about the future – the 'foreseeable future'. New application material relating to the judgement to be used in deciding the period to be used in carrying out parts of the assessment explains that it should be consistent with the periods appropriate for effective business planning and management. The implication of this material (which refers to 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) is that it may often be longer than the minimum of twelve months from the date of approval of the financial statements.

Observation

Boards may find consideration of events further into the future require significant changes to budgeting and planning processes. This may prove particularly challenging for subsidiaries. As medium-term strategic planning and stress-testing are a labour-intensive exercise and often carried out on a group wide basis:

• significant extra work may be needed for subsidiary financial statements signed off significantly after the group financial statements; and

• subsidiaries of overseas parents that are not themselves applying the draft 2013 Guidance may find that information beyond their own annual budget is not readily available.

Guidance for SMEs

Four paragraphs of guidance for SMEs explain that:

- whilst smaller businesses are often simpler, some may not be. The assessment should be appropriate to the particular circumstances of the company; and

- sensitivity analysis is likely to be needed even for smaller companies, whereas stress testing may not be.

> **Observation**
> In common with the 2009 Guidance, the draft 2013 Guidance applies to companies of all sizes. However, some of the drafting is clearly aimed at listed companies. It may be less accessible to smaller companies and, indeed, larger private companies.

Supplement for banks

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 2013 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.

> **Observation**
> The development of additional guidance for banks with input from the Bank of England is a welcome development, given the complexity of going concern judgements for bank directors.

Changes to International Standards on Auditing (UK and Ireland)

The FRC's Consultation Paper accompanying the draft 2013 Guidance also proposes that auditors of companies that apply the UK Corporate Governance Code must communicate their views to the audit committee on the robustness of the directors' going concern assessment and its outcome, including related disclosures in the annual report and accounts. They must also:

- read the directors' going concern statement (required by LR 9.8.6R(3)) and the description in the audit committee's report addressing the Board's judgements on going concern and consider whether, in relation to going concern, it is apparently misstated or inconsistent with the financial statements and their knowledge of the business; and

- state in their audit report whether, having regard to the work set out above, they have anything to add or draw attention to in relation to the disclosures made by the directors about the going concern assessment and its outcome, including the related disclosures in the annual report and accounts.

> **Observation**
> An explicit reference to going concern in the audit report will be welcomed by many investors. However, the test of "anything to add or draw attention to" may require further interpretation.

Effective date

The proposed effective date for the new guidance is periods commencing on or after 1 October 2012 with early adoption encouraged.

> **Observation**
>
> For many companies, the first accounting period for which the draft 2013 Guidance will apply has already started. If the finalised guidance is issued in June 2013, as planned, the more robust going concern process will apply to the half-yearly report of many listed companies.

More guidance for listed companies

A more detailed discussion of the corporate governance aspects of this proposal is available in a Governance in Brief: Going Concern: FRC proposes major changes which can be found **here**.

Further information on corporate governance matters can also be found at: www.corpgov.deloitte.com/site/uk

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