AT/BPC

Marek Grabowski
Director of Audit Policy
Financial Reporting Council
5th Floor, Aldwych House
71-91 Aldwych
LONDON WC2B 4HN

By email: m.grabowski@frc.org.uk

26 April 2013

Dear Mr Grabowski,

ICAS response to the Consultation Paper: Implementing the Recommendations of the Sharman Panel

The Institute of Chartered Accountants of Scotland (ICAS) welcomes the opportunity to comment on this FRC consultation paper (CP). ICAS's Charter requires it to act primarily in the public interest, and our responses to consultations are therefore intended to place the public interest first. Our Charter also requires us to represent our members' views and to protect their interests, but in the rare cases where these are at odds with the public interest, it is the public interest which must be paramount.

Key messages

ICAS is supportive of the original Sharman recommendations and intentions to improve the consideration of the going concern assessment and reporting thereon. This is consistent with our Future of Assurance report which states:

> *"The "front half" of the annual report should include…The rationale for concluding that the business is a going concern and an articulation of whether the period considered is limited to 12 months from the date of signing the financial statements or whether it is longer. This rationale should include:*
> - *disclosure of the key assumptions on which the Board has based its assessment;*
> - *a clear exposition of the business model and the strategy;*
> - *an articulation of the key risks facing the business (these should be limited in number and should reflect the risk discussions of the Board)…"*[1]

We also agree that the period which going concern is based on should be appropriate for the business, that responsibility to prepare the statement rests with the Board and that it is for the auditors to challenge and provide a more explicit audit report that the directors' assessment and assumptions of the company's going concern status is reasonable[2].

"The corporate report should flow logically through the story of the business, concluding where the Board sees the company in the future. "Going concern" is defined in company law and financial reporting terms as the company continuing for at least 12 months into the future from the date the financial statements are signed – but it does not have to be limited to 12 months. Boards should be

[1] Source: ICAS Future of Assurance report 2010 page 15, recommendations

[2] ICAS Future of Assurance report 2010 page 28, recommendations

CA House 21 Haymarket Yards Edinburgh EH12 5BH
enquiries@icas.org.uk +44 (0)131 347 0100 icas.org.uk

Direct: +44 (0)131 347 0231 Email: atelfer@icas.org.uk

encouraged to interpret the company's going concern status to cover a period appropriate for the business – which in some cases could be substantially longer than 12 months[3]*."*

We strongly urge the FRC in drafting the new guidance, to avoid forcing a conclusion, which risks the use of legalistic boilerplate language and to allow directors to make free form comment which is more meaningful for the reader.

It is essential that any disclosures are proportionate, sensible and focused. Guidance will need to provide flexibility to reflect different business models, organisation sizes and complexity. **The FRC proposals appear to apply to all companies which therefore run the risk of introducing a disproportionate burden on SMEs which should be avoided in the current economic climate**.

We are also concerned that the implementation timescales are too short and do not offer a reasonable period for businesses to digest and implement these far reaching proposals. Our understanding is that even large companies are likely to encounter implementation problems. **We believe that a transition period is needed which focuses on updating the existing 2009 FRC Guidance with the least radical proposals first – "think small first". This would allow additional time for the more complex proposals to be properly digested**. Going concern is an important and complex matter yet our overall impression from the consultation is that the FRC response has been rushed and not subject to sufficient interaction with the various stakeholder groups.

The presentation, style and structure of this CP is opaque and does not help to give us comfort that the FRC's proposals have fully encapsulated the intention and essence of Lord Sharman's recommendations. Key messages and conclusions need to be distilled more succinctly to ensure understanding and enable effective implementation. Illustrative examples and a model report would help. Further work is required to make this Guidance fit for implementation. We are not convinced at present that the FRC's proposals would pass its recently introduced test of "balanced, fair and understandable."

We understand that the UK has set out to seek harmonisation as far as possible with international accounting and auditing standards (as recently evidenced by the introduction of FRS 102). **We therefore believe it would be prudent to monitor developments in both the IASB and IAASB over the coming year whilst seeking to influence developments in the area of going concern**. Greater consistency is needed with international auditing and financial reporting standards to avoid confusing differences, particularly on the definitions.

Overall we believe that additional consultation is required before progressing, to minimise the risk of unintended consequences on business confidence or inadvertently encouraging companies to hold on to their cash which is contrary to the need for investment and growth in the current economic climate. Further details are set out below.

Scope of Guidance

The Guidance appears to apply to all companies. We believe that in the first instance, these proposals should be restricted to listed companies as set out in our response to the Sharman Inquiry in 2011[4] to reduce the risk of a disproportionate response. Our response stated:

"We believe in the first instance that these proposals should be restricted to listed companies. Over time we would like to see the principles being applied across all entities although we accept that there may need to be certain tailoring required for non-listed entities on the basis of proportionality to ensure that they are not faced with a disproportionate additional burden."

Greater clarity is required on what might be a requirement for an SME versus good practice. For example, stress tests are likely to be more challenging for smaller businesses to undertake and

[3] ICAS Future of Assurance report 2010 page 14, recommendations
[4] http://icas.org.uk/Businss_Issues/Submissions/

potentially disproportionate. Additionally, guidance should be provided as to when sensitivity analysis would be appropriate.

A need for clarity

There are a number of potential risks which the CP needs to address more robustly in its Guidance. Further clarity and examples of a model report would help. Care is required to avoid being too explicit on the business model which could open up commercial secrets. Care is also needed to avoid sending out the wrong messages to stakeholders, which can trigger a loss of confidence and result in a self-fulfilling collapse. Furthermore, changes need to be as practical as possible to avoid creating delays signing off the accounts as this can impact on bank support and create uncertainty in the marketplace.

The term "material uncertainty" would benefit from further clarification and the inclusion of examples to help to promote a more consistent approach across organisations and assist auditors when forming their respective assessments. The guidance appears to extend the meaning of material uncertainty so as that, if the directors cannot obtain a high level of confidence that the business will be a going concern for the foreseeable future, then material uncertainties arise. The foreseeable future appears to extend to the economic cycle.

As a high threshold will be required (both in terms of forecast period and a high level of confidence being required), it is possible there will be a significant increase in the number of companies not meeting this threshold and therefore reporting material uncertainties. As a result, the number of audit reports with an emphasis of matter paragraph will also increase. We do not believe this was the intention of the Sharman Panel and this is not in accordance with the accounting and auditing standards.

The supplementary guidance on banks recognises, although does not address, the risk that public disclosures of material uncertainty are likely to lead to a run on the bank. Again, greater clarity is needed, supported by examples. We are not convinced separate treatment of banks (or indeed other specific industry segments) is required. Our view is that the principles applied must be consistent across all sectors.

Current narrative in the Guidance is too general and discursive and needs to be tightened to facilitate implementation and minimise opportunities for misinterpretations. Our preference is an approach based on a clearly articulated set of high level principles[5]. Creating detailed rules increases complexity and can lead to boilerplate disclosures which does not give the necessary insight that users require. Principles allow companies to exercise judgement while maintaining a consistent approach to implementation.

The foreseeable future and an opinion on going concern

ICAS supports the need for flexibility in what the Board regards as the "foreseeable future[6]". Business models vary across industry, so in retail a foreseeable future may be measured in months in contrast to utility companies where such a measure will be in years. Directors need discretion to apply their judgement to develop what best reflects their business and it is for auditors to challenge the directors' awareness of the company's position, its risks and mitigating actions, assumptions and projections.

All companies want to give a positive message to their creditors and none of us know what is going to happen in 5 years. The Guidance must aim to avoid forcing a conclusion, which risks the use of legalistic boilerplate comments and to allow directors to make more meaningful free form comment. Readers should be able to come to their own conclusions based on the information provided that of course should be balanced, fair and understandable.

Readers' expectations need to be managed. Caveats are required to explain the limitations of predictability, for example, listing a risk does not necessarily mean it will/will not happen, or even

[5] See Principles Not Rules: A Question of Judgement (2006, Institute of Chartered Accountants of Scotland). (see http://www.icas.org.uk/site/cms/download/rs_Principles_v_Rules.pdf)

[6] CP Para 18a page 5 - Guidance

that it is a complete list of risks that the business is currently subject to at a point in time. One can only say what one believes is reasonable at that date, based on the information available. The onus is on the directors to demonstrate they understand the business; its operating environment; the medium and longer term; that they have a strong awareness of risks and how to manage these effectively and have taken reasonable steps to provide a balanced and informative report which meets the spirit of the reforms. The auditors are responsible for undertaking sufficient review and challenge, using their cross-lateral experience, to conclude whether the directors' assessment is balanced and reasonable.

Co-ordination with other bodies

Closer alignment with the definitions used by the international auditing and accounting standards boards is needed as operating two separate definitions of going concern are confusing and unhelpful.

We would encourage the FRC to facilitate a consistent approach to going concern with the IAASB and IASB, even if this means publishing and implementing the Guidance later. It is not clear from the CP what the FRC approach and position is with regards to these other bodies.

Implementation timescales

Although we welcome the best practice consultation period for this paper of three months, we are concerned that the effective date for the proposals was corrected to 1 October 2012, not 2013 as written in the CP. This means that the consultation is being undertaken for a period that has already started which makes the implementation timetable extremely short. We are concerned that this does not give business a reasonable time period to implement. Moreover, it is inappropriate to have a commencement period several months before the consultation on what the revisions are.

Consultation process

It is disappointing that the presentation style of this CP is opaque and does not facilitate clear assessment and challenge – a key driver for achieving a proposal which is fit for purpose. The document is cumbersome and time consuming to read. It needs to focus on the essentials. This is exacerbated by references which point the reader to external documents which are not part of the CP and a coding system for references in footnote 2, page 2 of the CP. Conclusions need to be clearer and highlight the changes in guidance to demonstrate the impact on existing practice more prominently. The structure does not start with each Sharman Recommendation, explaining how the FRC applied it (to allow the reader to evaluate the extent of implementation) and map it against the changes in the Guidance.

There is not a clear response on how the FRC have addressed each of the Sharman recommendations, for example, the FRC response to Panel recommendations 1, 2a, 2c and 5b are not included within the body of the report. The FRC response is cursory and oblique, by including this within the last paragraph of an Appendix titled "Final Recommendations of the Sharman Panel". This appears to be an afterthought and located in the wrong place. We do not believe this is adequate. A response to all Recommendations should be formulated and consulted on together, to help inform an overall view.

We hope this is helpful and would be happy to meet to discuss our comments further.

Yours sincerely

Alice Telfer
Assistant Director