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The going concern statement underpins stewardship – a long-term investor view

Introduction

Whether or not an entity is a going concern, and likely to continue in operation for the foreseeable future, is of vital importance to all stakeholders. Directors' confirmation that they believe a company is a going concern underpins the trust placed in it fulfilling its obligations. While the legal framework around how directors assess and communicate their opinion on companies' continued viability has been strengthened over time, the financial crisis – and the revelation of solvency issues in banks – exposed limitations in practice.

Long term investors need a robust stewardship going concern statement

We welcome the UK Government's commitment to implement the recommendations of the Sharman Inquiry (2012) to tackle these failures. Of particular significance to long-term investors is the clarification and strengthening of the "stewardship going concern" statement alongside the more widely understood "accounting going concern" assessment; the requirement for directors to consider longer-term solvency risks taking into account business cycle and other economic and financial factors; improved disclosures around the risks and assessment process; and an auditor opinion of the going concern disclosures[1].

A stewardship going concern statement, with supporting assessments and disclosures, is vital for two reasons:

1. To reassure the providers of capital (and other stakeholders) over the company's ability to continue to operate, and meet reasonably expected liabilities as they fall due. This is a matter of both liquidity and solvency.
2. To make clear directors' responsibility to manage the company prudently and for the long-term, not just to focus on short term challenges.

Taken together, the statement plays an important role in ensuring long-term and prudent behaviour, protecting capital, and strengthening responsible stewardship. This in turn underpins economic resilience and growth.

Key elements of a stewardship going concern statement

- **An explicit assertion by directors about the entity's expected future viability**. The going concern statement represents directors' best judgement of the entity's ability to continue in operation into the foreseeable future.
- **Supported by a clear articulation of business risks to the outlook**. While the statement sets out directors' opinion of the company's future, the risk assessment should provide an indication of the possible variation around this projection.
- **Grounded in 'true and fair' accounts**. The accounts must provide a reliable and prudent view of capital, including distributable reserves, such that directors have a solid basis on which to form a view about the future.
- **Covers the foreseeable future**. While directors should set the appropriate time frame (and justify this choice), the period of consideration should be considerably longer than the 12 months used for accounting purposes, and take into account the business cycle and other economic and financial factors facing the company.
- **Is a judgement, not a guarantee**. Directors are expected to provide their reasonable expectation of the company's viability based on available information at the time. Directors should not be held accountable for unforeseeable eventualities, and should be protected by safe harbour provisions.

A proposed stewardship going concern statement

The proposed statement below – with supporting guidance – meets the aims we have set out above, and is in keeping with the recommendations of the Sharman Inquiry.

The directors should confirm in the annual report that they have carried out a robust assessment of the state of affairs of the company and any risks, including to its solvency and liquidity that would threaten its viability. They

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[1] The Sharman Inquiry. "*Going concern and liquidity risks: lessons for companies and auditors*" Final Report and recommendations of the panel of inquiry. June 2012.

should state whether, in their opinion, the company will be able to meet its liabilities as they fall due and continue in operation for the foreseeable future, explaining any supporting assumptions and risks or material uncertainties relevant to that and how they are being managed.

Supporting guidance:
- First sentence: there needs to be specific reference to the assessment giving consideration to the audited accounts and financial controls and to the specific issue of whether there is a risk that the value of the company's assets may be less than the amount of its liabilities, taking into account its contingent and prospective liabilities.
- Second sentence: It needs to be made clear that 'foreseeable future' cannot be limited to 12 months and regards should be given to such things as the business cycle, contract lengths, the liability – including contingent liability – profile and other identifiable factors.

The statement should be required as part of the Financial and Business Reporting section of Corporate Governance Code.

Key areas of concern with recent Government proposals

The Financial Reporting Council is now consulting on modified requirements relating to the going concern assessment and statement in the Corporate Governance Code to put recommendations from the Sharman Inquiry into practice[2]. Several proposals have been put forward which we find troubling. These are outlined below.
- **Subsuming the "Longer-term viability statement" into risk management** - The going concern statement should not be subsumed within the *Risk Management and Internal Control* section of the Corporate Governance Code. This would frame the Going Concern assertion as a risk statement, which it is not.
- **The assessment of risks should be holistic.** Risks around the director's central projection need to be disclosed. This must not be limited to "principal risks" as currently proposed, but consider the risks to the business in the round[3].
- **Reference to accounts is important.** We believe the reference to audited accounts in supporting guidance is a critical part of any stewardship going concern statement as it makes clear the need for directors to root their judgement about the future in a firm understanding of the current capital position. Currently this is missing.
- **Specific terminology should not prevent progress**. We appreciate that terminology like "going concern" and "foreseeable future" is considered confusing by some. We are willing to consider alternative wording as long as the underlying principles set out in this paper are upheld.

Signatories

[2] FRC, "Proposed revisions to the UK Corporate Governance Code" Consultation document, April 2014.
[3] The phrase "principal risks" is often association with the COSO framework in the US, and more recently the UK's Turnbull guidance on internal controls. Both are driven by management's own assessment of the risks of them not delivering their objectives. In assessing Going Concern, we expect directors to take their own independent and holistic view of risks to the business, which may include the risks associated with the management's objectives themselves.

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