Association of Accounting Technicians response to Financial Reporting Council Exposure Draft Guidance on the Going Concern Basis of Accounting and Reporting on Solvency and Liquidity Risks

Association of Accounting Technicians response to ED: Guidance on the Going Concern Basis of Accounting and Reporting on Solvency and Liquidity Risks

1. Introduction

1.1. The Association of Accounting Technicians (AAT) is pleased to have the opportunity to respond to the Financial Reporting Council (FRC) Exposure Draft on “Guidance on the Going Concern Basis of Accounting and Reporting on Solvency and Liquidity Risks” (ED) published in October 2015.

1.2. AAT is submitting this response on behalf of our membership and for the wider public benefit.

1.3. AAT has added comment in order to add value or highlight aspects that need to be considered further.

1.4. AAT has responded to the questions set out in the ED and has focussed on the operational elements of the proposals and the practicalities of implementing the measures outlined.

1.5. Furthermore, AAT’s comments reflect the potential impact that the proposed changes to the guidance might have on SME’s, micro and nano-entities, many of which employ AAT members or would be represented by our operationally skilled licensed and regulated members in practice.

2. Executive summary

2.1. In the press release[1] issued by the FRC the objective of this guidance is stated as being to “enhance the quality and depth of information investors receive about the business over the longer term”. AAT fully supports this objective and considers that it is important for all users of financial statements to be sufficiently informed as to significant threats to solvency, liquidity or viability (5.1, below).

2.2. Where there are material uncertainties which cast significant doubt upon the suitability of the going concern basis of accounting, AAT supports the guidance given that, while it is appropriate for financial statements to be prepared on a going concern basis, disclosure should be made of the uncertainties so that users can make their own judgement as to the potential impact of the uncertainties on the entity’s financial position (3.3-3.6, below).

2.3. AAT fully supports the publication of the proposed guidance but is of the opinion that it would be helpful if it is made clear that it covers two primary concepts; one relating to identifying when the going concern basis of accounting is not appropriate and the other relating to the disclosure of information so that users of financial statements can understand significant uncertainties that impact on solvency, liquidity or viability (3.5, below).

2.4. AAT sees a significant obstacle to the full disclosure in financial statements of significant risks which may impact on the appropriateness of the going concern basis of accountancy or concluding that the going concern is not appropriate, due to the natural tendency for directors to view their entity’s future prospects with optimism and an unwillingness to publicly disclose weaknesses (3.4, below).

[1] https://www.frc.org.uk/News-and-Events/FRC-Press/Press/2015/October/FRC-proposes-new-guidance-to-enhance-reporting-on.aspx

3. AAT Response to the FRC Exposure Draft on “Guidance on the Going Concern Basis of Accounting and Reporting on Solvency and Liquidity Risks”

Question 1
Do you agree with the scope of the guidance as set out in section 1?

3.1. AAT agrees, in broad principle, with the scope of the guidance as set out in section 1 of the ED and considers it helpful to preparers of financial statements to have a single point of reference as regards accounting for the consequences of the risks which threaten a going concern basis.

3.2. It is particularly helpful for smaller and micro entities to be able to recognise when the going concern basis of accounting is not appropriate or when significant threats to solvency, liquidity or viability should be disclosed.

Question 2
Is the guidance sufficient for the different types of company that fall within its scope?

3.3. On the basis of drawing the directors’ attention to indicators of situations where the going concern basis may not be appropriate and the consequences of using the going concern basis inappropriately AAT considers that the guidance is sufficient.

3.4. The greatest difficulty to overcome is the natural reluctance of an entity to acknowledge that its going concern is at risk in situations other than those in which the closure of operations is planned.

Question 3
Do you agree with the draft guidance on the assessment of solvency and liquidity risk as set out in paragraphs 4.1 to 4.6?

3.5. The assessment of solvency and liquidity risk as set out in paragraphs 4.1 to 4.6 of the ED provides proper guidance to directors as to the thought processes required in considering threats to solvency and liquidity. However, again, it is difficult to take an objective independent view of the entity’s solvency and liquidity position in all but the most extreme situations and there is a natural tendency for directors to conclude in other than extreme situations that any possible threats are not significant to the financial statements and that preparers of financial statements do not readily disclose information on threats to solvency or liquidity.

3.6. AAT considers that a change of mindset is required to encourage directors of entities with weak balance sheets not only to disclose such threats but also to indicate how those threats might be ameliorated in the future.

Question 4
Does the draft guidance sufficiently distinguish between the assessment of and reporting on the ‘narrow’ going concern basis of accounting (section 3) and the broader concept of solvency risk and liquidity risk (section 4)?

3.7. The three reporting scenarios set out in section 3 of the ED provide a helpful summary of the approach to be taken by directors but it is the middle scenario requiring the disclosure of material uncertainties which casts significant doubts on the going concern basis which will give rise to the most difficulties in practice.

3.8. As previously stated (2.3, above), directors will be reluctant to conclude that there are doubts in respect of going concern in the future if they do not currently exist. Such evaluations require a totally unbiased and open minded approach by directors.

3.9. It is essential that there is a change of mindset on the preparation of financial statements generally that a “true and fair view” as regards going concern is not just a matter of identifying when an entity will be unable to continue activities, but that it is the norm for financial statements to disclose significant threats to solvency and liquidity.

3.10. It would be helpful if it is made clear in the introduction to the ED that the guidance relates to two primary concepts. Firstly that of identifying when the going concern basis of accounting is not appropriate and secondly the disclosure of information concerning significant uncertainties which may have an impact on solvency, liquidity or viability so that users of financial statements can make their own assessments as to the potential impact on the entity.

3.11. As referred to in 3.5 above, AAT considers that there needs to be a general change of mindset for preparers of financial statements to readily provide disclosures of threats to solvency, liquidity or viability.

Question 5
Does the draft guidance adequately highlight the relationships between the concepts (section 2)?

3.12. AAT considers that section 2 of the draft guidance does adequately highlight the relationships between the concepts. The difficulty for directors is that the assessment essentially calls for a “black” or “white” conclusion, being whether the going concern basis for the entity is sound for the foreseeable future and many situations are not this clear cut.

3.13. Furthermore, it is potentially difficult for directors to conclude that, while the financial statements may be presented on a going concern basis, additional disclosures are necessary for such to provide a true and fair view. This requires a mindset which is focussed on providing helpful information to the reader of financial statements, rather than the minimum disclosures possible.

Question 6
Do you consider that the guidance is sufficiently practical? If not, how might the guidance be improved?

3.14. AAT considers that the guidance is useful but it cannot overcome the difficulties of directors publicly acknowledging threats to the entity’s going concern due to unwillingness to publish potentially sensitive information, a lack of objectivity and possibly reluctance to report a potential self-fulfilling prophecy. This attitude of mind can only be overcome by changes to reporting requirements such that financial statements include details of all significant threats and uncertainties, subjectivity, judgement or bias applied in preparing the financial statements so that readers can make their own assessment as to the levels of prudence reflected in the financial statements, not just as regards whether the going concern is in some doubt.

3.15. AAT does not consider that the model shown as figure 1 under 2.4 in the ED is helpful to the guidance. It is difficult to interpret what principles are being illustrated. It is assumed that it is intended to provide a decision flow chart of the evaluation of risks leading to the going concern basis being appropriate. If this is the case, AAT believes it would be more helpful to users if the guidance to be provided with a simple decision flow chart such as:

- Evaluate all risks
- Identify the principal (significant) risks
- Identify principal risks which cast significant doubt on liquidity, solvency and viability and disclose in financial statements
- Identify material uncertainties when going concern basis is not appropriate.

4. Other comments

4.1. The difficulty of directors not being fully objective in considering going concern issues might be overcome by requiring such information to be disclosed in auditor's reports as regards the significant elements of the financial statements which are based on subjectivity, uncertainty, judgement or bias contained in financial statements.

4.2. It would also help to include their conclusions on significant threats to solvency, liquidity or viability, which is of greater benefit to users than the statement that the financial statements represent "a true and fair view" so that the users can then understand the degree of any uncertainties as well as the margins of subjectivity inherent in the financial statements and form their own opinions as to the degree of prudence reflected in the financial statements.

4.3. For small entities that are exempt from audits on the basis of being below the size thresholds, a requirement for their financial statements to be prepared by an independent firm of accountants holding a recognised professional qualification and being regulated by a professional body would enable users to have an improved level of confidence in the contents.

4.4. The basis of preparation, limitations and threats as regards uncertainties potentially impacting on the reported results and financial position (similar to the additional information suggested for inclusion in auditor's reports on audited financial statements referred to in 3.4-3.6 above) would be disclosed in an attached report.

4.5. In this way the independent firm will be responsible for making judgements as regards the application of prudence in particular and for providing users with sufficient information to understand the risks attaching to the financial entitlements particularly as regards liquidity, solvency or viability. All financial statements prepared internally by the entity itself or by other unregulated persons should be subject to audit whatever the size (but perhaps subject to a de minimus turnover limit of £500,000 per annum in line with the exemption for charities).

5. Conclusion

5.1. Those entities which are required to publish a Strategic Report will provide details of trading policies adopted by the directors but will not necessarily give details of the underlying risks, subjectivity or potential errors in estimates. While FRS 102 and IFRS 7 require the disclosure of material financial risks by large and medium sized entities financial statements, there is a need for the disclosure of all significant risks to liquidity, solvency or viability for all entities.

5.2. AAT believes that users of financial statements for entities of all sizes need more disclosure of details of the significant subjective elements contained in those financial statements, particularly as regards significant threats to solvency, liquidity and viability and, while this guidance addresses this issue, AAT has made proposals for providing such information on a credible basis (4.1 and 4.2, above).

6. About AAT

6.1. AAT is a professional accountancy body with over 49,700 full and fellow members[2] and 85,500 student and affiliate members worldwide. Of the full and fellow members, there are over 4,200 members in practice who provide accountancy and taxation services to individuals, not-for-profit organisations and the full range of business types.

6.2. AAT is a registered charity whose objectives are to advance public education and promote the study of the practice, theory and techniques of accountancy and the prevention of crime and promotion of the sound administration of the law.

7. Further information

If you have any questions or would like to discuss any of the points in more detail then please contact AAT at:

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[2] Figures correct as at 31 Dec 2015