NAPF
Securing the future of pensions

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Dear Catherine

Consultation Paper: Risk Management, Internal Controls and the Going Concern Basis of Accounting

You will be aware that the NAPF was supportive of the development of the Sharman recommendations and of the FRC's proposed implementation of the Sharman Inquiry as set out in January 2013. We were of the view that the objective of promoting further consideration by company boards, and subsequent managing and reporting, of their solvency and liquidity risks would add real value for shareholders and bondholders. We were firmly of the view that the Sharman Panel recommendations assist confidence by requiring richer risk disclosures from companies and knitting together these with the approach on going concern.

We have been in dialogue with FRC staff regarding these proposals and we have been struck by two specific comments which they have considered in reflecting on the feedback they have received on the consultation:

1. That there is a risk of confusion from the dual use of the term 'going concern' in what has been called a common sense way, and in the narrower accounting sense. We note that the current explicit statements that directors make about the going concern nature of their company are restricted to this narrower sense, meaning these statements are of less value than investors perhaps perceive.

2. The difficulty of requiring directors to make definitive statements as to ongoing viability without introducing excessive caveats; a difficulty that increases with the prolongation of the period with regard to which boards are asked to make such statements.

In our consideration of this matter we have reached three key conclusions:

1. Potential value from setting aside 'going concern' terminology

We acknowledge that the use of the term 'going concern' in relation to accounting is not in the FRC's gift, and we therefore accept the FRC's judgement that avoiding the use of this phrase in its more common sense way should in fact add to the substance of the requirements of directors, not detract from them. In this, we have been influenced by the way in which the current going concern disclosures have been narrowed unhelpfully to the accounting sense of that term. We thus agree that it is appropriate to abandon language that is at risk of becoming devalued and that the Sharman Panel's intent of more holistic risk assessments are likely to be better delivered by using other, richer language.

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2. **A broader approach than solvency and liquidity**

In some of their communications, FRC staff have referred to disclosures around solvency and liquidity as amounting to an assessment of the likely survival of the company. We are concerned that the two terms may be more narrowly understood than this in practice, and thus would welcome the language of survival or viability of the company being employed such that it is clear that the approach encompasses all principal risks which might impact the ongoing viability of the company (ensuring that matters such as a licence to operate are included in any such assessment).

3. **The need for an explicit statement**

While we accept that – given its devaluation through the use of the narrow accounting understanding of 'going concern' – the removal of Code requirement 1.3 does not in practice lead to any significant reduction in the assurance provided to shareholders and bondholders, we are concerned at the loss of an explicit statement in this respect. We do not believe that an implicit assurance from directors is sufficient. Our experience is that explicit assertions are more likely to receive detailed attention from boards, and that they are also likely to be more closely considered by auditors. We would thus argue that there needs to be a requirement for an explicit statement by boards in respect of the ongoing viability of the company.

Possible language to be employed

In dialogue with other investor representatives we have developed the following language as a possible way of addressing these issues. This is intended to replace Code requirement C.2.1:

> "The board should confirm in the annual report that it has carried out a robust assessment of the principal risks facing the company, including those that would threaten its solvency or liquidity, and report how the principal risks are being managed and mitigated. The board should confirm that it considers that the company will continue to be viable and to be able to meet its liabilities as they fall due for at least 12 months from the date the financial statements were approved, and report any material uncertainties to that assertion as necessary".

We note that the FRC may consider that seeking such a positive assertion from boards might be accompanied by unhelpful caveats such that the apparent value of the assertion could be undermined. If this is the case, the FRC might prefer to consider requiring an explicit disclosure in a negative form, such as "The board should confirm that it has identified no material concerns that it believes it needs appropriately to disclose to shareholders or bondholders with regard to the company's viability for at least 12 months from the date the financial statements were approved, or alternatively report any such material concerns."

We commend these relatively minor changes to the current proposal and hope that they will assist the FRC to deliver its objectives and the aims of the Sharman Panel, thereby adding significant value to investors and the market. Please do not hesitate to contact me if it would be helpful to discuss this further.

Yours sincerely

Paul Lee
Head of Investment Affairs