Accountants &
business advisers

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Our ref: RSB/nyk

30 June 2011

Dear Sirs

Going concern and liquidity risks: Lessons for companies and auditors

We welcome the opportunity to provide evidence to this important Inquiry to identify the lessons that can be learnt in the aftermath of the credit crisis for companies addressing going concern and liquidity risks. We agree that the quality of information companies provide to assist in an analysis of their financial health and their ability to withstand short to medium term stresses is of vital importance in underpinning market confidence and stimulating growth.

We welcomed the initial guidance issued in November 2009 addressed to the directors of all UK companies as this placed the onus on those individuals to consider going concern. The directors of non-listed companies often seem in practice to regard this as an issue for the auditors to address, as the only meaningful guidance on the subject was embedded within Auditing Standards (Statements of Auditing Standards (SAS) 130 The going concern basis in financial statements and, subsequently, International Standards on Auditing (ISA) 570 Going concern). Whilst the guidance addressed to all directors was therefore helpful, it continues to be the case that private companies, except the largest, continue to place reliance on advice from their auditors in these areas. We therefore regard the potential proposal by BIS to remove the requirement for medium sized companies to have an audit as a retrograde step.

We have consulted internally amongst experts and practitioners in our Audit and Assurance, Corporate Finance, Corporate Recovery and Forensic departments to harness their combined skills and experiences in preparing our response.

Transparency of going concern and liquidity risk

1. *What combination of information about:*

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- *the robustness of a company's capital;*
- *the adequacy of that capital to withstand potential losses arising from future risks; and*
- *the company's ability to finance and develop its business model,*

Would best enable investors and other stakeholders to evaluate the going concern and liquidity risks that a company is exposed to? How effectively do current disclosures provide this information?

1.1 The information that would best enable investors and other stakeholders to evaluate the going concern and liquidity risks is arguably the same as that used by management in assessing those risks. Typically, this might involve providing detailed cash flow and profit forecasts, comparison of forecast cash demands with funding facilities and covenants, stress testing the key assumptions made in forecasts such as sales growth, gross margins and working capital requirements and providing sensitivity analyses.

1.2 Auditors will typically perform their own review, analysis and critique of these forecasts including a comparison of historic forecasts with actual results.

1.3 However, it is not necessarily in the interests of those stakeholders for that information to be publicly available as it would provide invaluable insight for competitors. Instead investors must, to an extent, rely on the assessments made by management.

1.4 Therefore it is important that management clearly and comprehensively set out the processes they have in place for assessing going concern and liquidity risk. Currently, such explanations are often bland boiler-plate representing little more than a statement of their responsibilities. Instead they should reflect the specific steps taken in the assessment process.

1.5 Where the forecasting and assessment process has identified potential risks then these should already be disclosed either as part of the business review analysis including principal risk and uncertainties or, if they cast significant doubt over the company's ability to continue as a going concern then as a material uncertainty.

1.6 It would also be useful to stakeholders to have more thorough explanations of the company's business model, including its operating gearing, and its financial and operating flexibility.

1.7 Such improvements in the quality of the disclosures could be achieved through clearer and more precise disclosure requirements supported by a process of external assurance review and regulatory enforcement. However such a regime would have to consider carefully the scope of any assurance and incorporate some form of liability reform.

2. *What type of disclosures (if any) have been made into the market place outside annual and interim corporate reports about current stresses being experienced by the company and about the management of those stresses? How do these disclosures interact with the requirement to disclose principal risks and uncertainties in the Business Review and the required disclosure on going concern and liquidity risk in the annual and interim financial statements?*

2.1 The majority of our client base has made few announcements in relation to going concern or liquidity risks. The main comments are in association with fund-raisings, both equity and debt, (particularly for the mineral exploration companies) which are required to progress exploration or develop mining facilities.

3. *Are there any barriers within the current corporate reporting environment to companies providing full disclosure of the risks associated with going concern and liquidity both within and outside the company's annual and interim reporting? Are there any changes that might be made to encourage companies to give fuller and more transparent disclosures in this respect?*

3.1 It should be noted that financial reporting standards, company legislation and regulatory requirements already mandate the provision of a wide range of information on going concern and liquidity risk and companies do generally comply with these requirements to a material extent.

3.2 However, there are a number of barriers to extending these disclosures and potentially improving their quality. We consider the key ones to be as follows:

3.3 The commercial sensitivity of the information. As discussed in our answer to question 1 there is a legitimate justification for retaining the confidentiality of much of the information used by management in assessing these risks. It may be in the interests of investors and other stakeholders that some useful information is not in the public domain.

3.4 The fear of litigation, particularly in respect of forward looking information. This fear can only be alleviated by the introduction of clear and enforceable safe harbours for both the preparers of the financial statements and those reporting thereon (i.e. the auditors).

3.5 Natural disinclination, particularly amongst private companies, to provide more than the bare minimum to achieve compliance. The solution to this problem would be to have more detailed disclosure requirements supported by a process of external assurance and regulatory enforcement. Whilst the disclosures within the financial statements, such as those required by IAS 1 in respect of material uncertainties and IFRS 7 on liquidity risks are subject to audit there is very little direct assurance given on compliance with regulatory requirements in preparing the narrative reports – for publicly listed premium traded companies the auditors are only required to review the going concern statement prepared by the directors.

4. *Given the current measurement, recognition and disclosure requirements of International Financial Reporting Standards (IFRS), how effective are IFRS financial statements in enabling stakeholders to evaluate the robustness of a company's capital in the context of the going concern assessment? Are there any changes that could be made to these requirements that would better enable them to do so?*

4.1 Taken as a whole, the disclosure requirements of IFRS should provide a significant amount of useful information for the evaluation of a company's going concern status and liquidity risk. These range from the requirement to disclose any material uncertainties casting significant doubt on the entity's ability to continue as a going concern, to extensive disclosure on financial risks, including liquidity, in respect of its financial instruments to the analysis of operating segment information including reliance on major customers.

4.2 Concerns are raised about the use of fair value accounting, particularly in respect of financial investments, and the impairment of financial assets that are not measured at fair value though many of these concerns have been or are being addressed by the IASB.

4.3 There are instances where fair values derived from valuation models, so called "marked to models" accounting, can suggest a level of accuracy in that valuation that does not exist. However, the need to disclose the valuation methodology, highlighting those that are not based on market information, and to provide details of the assumptions and the sensitivity of values to those inputs provides a context for stakeholders in assessing liquidity risk.

4.4 The alternative of not measuring at fair value could be seen as reducing the usefulness of information if assets are valued at historic rates.

4.5 In our view, neither solution could ever be perfect without perfect information but on balance we support the use of fair value measurement to the extent mandated in IFRS given the contextual information provided. These disclosures will be expanded with the application of IFRS 13 for years commencing on or after 1 January 2013.

4.6 Further concerns were raised on the timing of the recognition of bank losses at the height of the banking crisis. Again, the IASB is addressing these concerns and will require much earlier recognition with a move to an "expected loss" model rather than an "incurred loss" model.

4.7 However, the standards are only as good as their implementation. The FRC has noted the cluttering effect of "boiler plate" disclosures or the inclusion of immaterial disclosures arising from a checklist approach to compliance with the standards. We welcome their project to deal with these phenomena and would urge greater dialogue between regulators, auditors, preparers and users to deal with the problem.

Company assessment of going concern and liquidity risk

5. What processes are undertaken by directors in making their assessment of whether the company is a going concern when preparing annual and half-yearly financial statements?

- *Which records and information are referred to in making this assessment?*
- *What type of model does the company use to develop scenarios to stress-test the assumptions that have been made when making this assessment?*
- *What types of risks are included in the going concern assessment: financial, strategic, operational, other? How are these presented in the assessment?*
- *What is the role of the audit committee and risk management committee (where one exists) in this process and what inputs do they receive in order to carry out this role?*
- *What impact has undertaking the going concern assessment had on the planning and management of the company?*
- *How has the assessment of going concern and liquidity risks been incorporated into other aspects of company stewardship and reporting?*
- *How effective is this assessment in addressing the robustness and adequacy of a company's capital and its ability to continue financing and developing its business model? What, if any, improvements could be made?*

5.1 The process undertaken by directors varies from client to client, primarily based on the level of risk they perceive in relation to going concern and liquidity. The majority of our client-base uses relatively straight-forward Excel models looking at monthly cash flows based initially on an annual budget and consequently for a period of twelve months. These models may allow some sensitivity analysis to be undertaken so that the cash flows can be flexed. For clients where cash is particularly sensitive they may have weekly short-term cash flow forecasts available, say for the following three months, which then revert to the more usual monthly forecasting thereafter. The overall length of the forecasts may extend beyond 12 months: but this is often instigated by the auditors who often have to remind clients of the requirement to look at 12 months from the date the financial statements are approved as opposed to from the balance sheet date. Renewal of funding facilities shortly after the review period may also prompt clients to prepare forecasts for a longer period.

5.2 Strategic and operational issues are built into the models where appropriate. For example, in the case of many companies their forecasting models will differentiate between committed and discretionary expenditure to allow for scenarios where fund-raisings may/may not be successful.

5.3 We consider that for private companies, the requirement to produce budgets and cashflow forecasts is often driven by the auditors. In this respect the FRC guidance has been of assistance in enabling auditors to draw directors' attention to relevant guidance.

5.4 Some issues can arise where companies attempt to stick rigidly to budget and cashflow models based on an annual reporting cycle given the requirement to consider a period of at least 12 months from the date of approval of the financial statements. In certain cases clients are uncomfortable when they feel they have to produce forecasts outside their "normal" formal reporting process.

5.5 Another issue which needs to be taken into account is whether the underlying budgets are "fit for purpose" as a basis for a cash flow forecast as they could be prepared with different objectives (to incentivise, as a measure of performance). An understanding of the basis on which the budget has been prepared is therefore critical.

5.6 We would note that companies that prepare cash flows solely to mark an accounting deadline will be unlikely to have truly valid data to support the unwinding of period end balances. The resulting "assumptions based on assumptions) may conceal a problem that might have been clear had rolling forecasts been standard.

6. *What is different about the review of going concern when raising capital compared to the annual going concern assessment undertaken for accounting purposes? Could some of the different procedures be used in the annual accounting or audit assessments?*

6.1 The main difference is essentially one of depth. A review for working capital purposes is a significantly enhanced version of that done for going concern purposes although they are both built around the same general principles of looking at key assumptions, headroom and availability of borrowing facilities.

6.2 The other key differences are that for a working capital review the advisor is expecting necessary funding to be in place and secured i.e. not renewable in the period and not repayable on demand, such as an overdraft and account is not usually taken of actions that management could take to raise funds if required e.g. asset disposals.

6.3 The annual going concern assessment, and related audit assessment, often has to take into account more uncertainty and some reliance invariably has to be placed on intentions. For example, if a banking facility is due for renewal in the period under review the auditor may seek negative assurance from the lender that they are not aware of any reasons, at the current time, as to why they might not continue to provide facilities in the future. Whilst shareholders and investors might prefer the higher level of assurance that is provided by the working capital style review there would be significant implications for cost, not only from higher audit fees but potentially increased lending fees if banks are being asked to commit facilities for longer periods.

7. *Does the company assess future cash flows and liquidity on a regular basis throughout the year? If so, how regularly is this done and is the information used any different to that used in the annual and half-yearly assessment for the purpose of preparing financial statements?*

7.1 This will be highly dependent on the nature of the entity and its cash requirements. Examples we have seen in practice include:

- Weekly short-term forecast, say for three months, moving to monthly forecasting (as noted above)
- Monthly cashflow with rolling annual forecast
- Monthly cashflow forecast driven by annual budget process

7.2 The clearest evidence auditors are usually able to obtain relating to on-going assessment of cash flows is from review of the minutes of Board meetings when those charged with governance, for public companies including the non-executive directors, consider cash requirements. The nature of these discussions tends to vary depending on how urgent the cash need is or renewal of funding facilities as opposed to being driven by the timing i.e. annual and half-yearly. Companies have to give extra consideration at the various reporting dates to articulating their conclusions on going concern for publication which does sometimes add focus to their thoughts.

7.3 For smaller private companies the evidence is often more limited and may only be indirect. In some cases the only overt consideration of cash flow is as a consequence of a requirement to submit monthly management accounts to a lender.

8. *To what extent and how do directors assess the viability of a company over the course of its natural business cycle?*

8.1 In the start up phase the majority of businesses are highly dependent on funding from shareholders – in some cases from "friends and family". Whilst the threshold for "going concern" remains the same in the early days of an enterprise it is likely that both the directors and investors (sometimes one and the same) will accept that the uncertainties will be greater.

8.2 In the second phase, and taking an example from our client base, when a mineral exploitation company moves from the exploration phase to a mining company, significant bank funding may be required. This will usually require the production of extensive budgets and cash flow forecasts and the first time that the company will be subject to regular external monitoring of on-going results (aside from shareholder and general market interest). This introduces the company to a different level of discipline and requires a more rigorous review.

8.3 We do not consider that directors in the UK typically consider the consequences of wrongly trading (trading when they knew or ought to have known that the company could not avoid insolvent liquidation) until it is too late. However, the likelihood of action being taken against them remains remote.

9. *The current model of disclosure identified three categories of company. What sort of behaviours does this model drive? Is there a different model that might be useful? Would more guidance on the application of the current model be helpful?*

9.1 This model is deeply rooted in existing regulations such as UK GAAP, IFRS and auditing standards and is generally well understood as it effectively acts as a "traffic light" system.

9.2 In our experience the use of the third category – the going concern basis is not appropriate – is usually clear cut and the fact that an entity is not a going concern will usually have been established before the accounts are prepared e.g. a property investment company where all the properties have been sold and the entity's only on-going reason for existing is the orderly distribution of the remaining funds. If the fact that an entity is not a going concern is identified during the course, say, of the audit this would usually indicate that those charged with governance had not been carrying out their duties appropriately and potentially results in the entity ceasing to trade and no accounts being finalised.

9.3 The main difficulty that arises is in the difference between categories one and two which reflects the judgemental and subjective nature of going concern assessments. In both situations the accounts are prepared on the presumption that the company will continue as a going concern, with the second being applied where there is a "significant doubt" that this may be the case. Only with a consistent presumption of the company being a going concern can there be consistent measurement and presentation to permit comparison.

9.4 The difficulty in application is what constitutes a "significant doubt" as this is subjective and is open to interpretation. It could be argued that this category is too broad and does not provide users with a clear indication of the importance of the issue. Exploration companies often only raise sufficient funding to see them through the next phase of activity and will need to raise funding within the period under review. The company's ability to raise this funding would give rise to a significant uncertainty, but this would not be seen to cause undue alarm to the markets.

9.5 Whilst the acknowledgement of "significant doubt" can carry negative connotations for some businesses for others, particularly at certain stages of their life cycle, this may be seen as usual e.g. as referred to above for early stage exploration companies. Alternatively a similar comment included in the financial statements of a well-established company would cause concern and could actually precipitate a company's failure. Some directors, particular in the former case, consider that the additional disclosures provide an element of protection as it draws attention to a key risk that an investor should be aware of. In the latter case directors may shy away from making appropriate disclosures as they are all too well aware of the possible ramifications.

9.5 There could be further sub-division to permit the preparers and auditors to provide an assessment of the quality of the risk and going concern disclosures made by the company but this might result in a more formulaic assessment which might not be helpful to the users.

10. In your experience, what issues have resulted in a heightened focus on the assessment of going concern? What was the nature of the risks that gave rise to these circumstances? Had these risks been identified in advance, and if so, how?

10.1 Issues that have resulted in a heightened focus on the assessment of going concern have included:

- Failure of the company to perform in line with expectation resulting in a worsening cash position.
- Breach of loan covenants.
- Continued availability of finance where facilities are due for renewal, length of time involved to renegotiate and/or tightening of covenants.

10.2 Failure to perform in line with expectation should usually be identified through review of management accounts etc. but a sudden dramatic fall-off in performance for an entity already experiencing some difficulties can be of particular concern. Depending on the nature of the business more careful monitoring of, say, the forward order book could assist in ensuring issues are flagged early.

10.3 The requirement to reclassify debt as due on demand at the financial period end where a covenant has been breached and the breach has not been subject to waiver by the lender in advance (FRS 25 para 50 (c)) of the year end has taken some directors by surprise. Even if the matter is resolved post period end the financial statements can show a very negative picture on the face of the balance sheet. Clients who are aware of the risk and proactively monitor the situation can obviously avoid this predicament.

10.4 The majority of clients are aware of when financing facilities are due for renewal and provided they are cognisant of the likely lead times involved in obtaining new facilities then this should not be an issue.

The auditor's approach to going concern and liquidity risk

11. How does the auditor approach the assessment of going concern and liquidity risk? To what extent does this involve the testing of the company's processes and what other work is carried out? Is there any specific reporting on the work done by the auditor on going concern and liquidity risk to Audit Committees? Does the assessment of going concern involve different processes in certain industry sectors? Are there different processes used where there is overseas reporting in addition to UK reporting?

11.1 The auditor's approach to going concern is primarily driven by the relevant Auditing Standard (ISA (UK and Ireland) 570). We have taken certain elements of the standard and embedded them directly within the firm's audit software e.g. the list of examples of events or conditions that individually or collectively may signify that a material uncertainty may exist regarding the going concern assumption is included as a checklist which has to be completed both at the risk assessment and final stages of the audit.

11.2 The nature of going concern considerations are such that, whilst we may evaluate the design and implementation of the controls that the company has over this area e.g. management and those charged with governance may review cashflow forecasts and budgets at monthly Board meetings, we would not seek to place reliance on such a control. We would always look substantively at the year end position and future forecasts and look for supporting evidence for management's assumptions where available. We consider past forecasting history to assist in our assessment of the robustness of management's capabilities in this regard. These points are emphasised in our internal guidance on the approach to be taken in auditing this area.

11.3 Whilst we are required to consider going concern on all companies the nature and extent of the work undertaken will depend on whether, at the planning stage, we have assessed this to be an area needing special audit consideration i.e. a significant risk. Where either we have assessed there to be a significant risk attached to the going concern assumption and/or we have concluded that a modified opinion will be required this would be communicated to and discussed with the Audit Committee. This may also impact on when in the audit process we carry out work in this area. If appropriate the engagement partner may direct the audit team to carry out work on going concern at the start of the audit, partly to limit the audit firm against exposure to non-payment of fees and related ethical concerns.

11.4 We consider that there is still some lack of clarity regarding the nature of evidence that it is anticipated that directors will produce for review. ISA 570 (app 8) states, for example, that when there is a history of profitable operations and a ready access to financial resources, management may make its assessment without detailed analysis. Where a company has sizeable cash resources and limited committed cash outflows indicating that it can continue to trade for at least 12 months after approval of the financial statements and for a reasonable period thereafter without having to raise further funds, we would not expect the client, necessarily, to produce a forecast and hence there would not be a formal forecast for the Board to approve. However, we are aware that this may regarded as inappropriate in some quarters. We consider that for auditors to be able to achieve change and/or improvements in this area, further guidance needs to be provided to those charged with governance as this is first and foremost a governance issue.

11.5 We have not been exposed to any different processes in relation to overseas reporting as the majority of our client base where this is relevant report into Canadian or Australian jurisdictions where the requirements are similar.

Feedback on the Guidance for Directors of UK Companies in respect of going concern and liquidity risk

12. Do you believe that amendments to the Guidance for Directors of UK Companies in respect of going concern and liquidity risk would be helpful? For example:

- *Guidance for directors on disclosures does not specify the language to be used, whereas auditors use more standardised wording. Is this helpful?*
- *Is there a need for a clear boundary between the three types of company?*

12.1 We consider that additional guidance to directors on potential wording within the "basis of preparation" note would be of assistance. As is noted auditors use more standardised wording as this is set out in related guidance. Given that the trigger for an "emphasis of matter" modification is that there are "material uncertainties" that may cast a "significant doubt" about the ability of the company to continue as a going concern and these are phrases that are used in the auditor's opinion it might be expected that this wording would be mirrored in the "basis of preparation" in the financial statements. However, there is nothing that specifically states that this should be the case and it can therefore sometimes appear that the auditor is painting a bleaker picture than that by the entity itself.

12.2 This potentially indicates that there may be a need to split the second category into two so providing users with two considerations. The first would be where the going concern is dependent on external factors such as renegotiating of bank facilities but where this is part of the "normal" business cycle in that these are generally subject to annual renewal as compared to those where substantial financing is required from, say, a call on shareholders where the outcome may be less certain.

13. Are there any other views that you would like the Panel of inquiry to take into account?

Inherent limitations of periodic reporting

13.1 It should also be noted that there is a limit to what can be achieved through the annual report. This is partly due to the speed of change in the modern economy, partly due to the impossibility of providing perfect information about past, current and future events and partly because it is not in the interests of the company or its stakeholders for certain useful information to be in the public domain.

13.2 On the one hand, no amount of disclosure can ever provide absolute protection from the unpredictable shocks that result in business failures. The marginal benefit of each additional disclosure requirement should be assessed and compared to the cost of compliance, especially in a report which is already considered cluttered.

13.3 On the other hand, investors do not rely solely on the contents of the annual report when assessing the robustness of a company's capital and its business model. Furthermore, the use an individual investor or analyst makes of this information will be different to the next. What they want is the information or data to perform their own analysis rather than the analysis of others – the annual report should provide this information but we would be wary of additional analysis such as liquidity ratios or Altman Z-scores being mandated.

13.4 With regards to the speed of information, the annual report is already supplemented by half-yearly reports, management statements, presentations to analysts and public statements of price sensitive information. The contents of these statements and the extent to which as a whole they meet the needs of investors and society at large should also be considered.

13.5 Finally, the most important limit on the quality, amount and relevance of information is its commercial sensitivity. Information on customer orders, operating margins, cost structures, cash flow forecasts are all necessary for performing a thorough going concern assessment but such information is commercially sensitive such that the company, and by direct correlation its key stakeholders, would be at a disadvantage if this information was publicly available in the annual report.

13.6 At the heart of the investor/company relationship there must be trust in the assessments made by directors supported by the assurance given by their assessments being subject to external audit. This trust is strengthened by clear explanation of the business model, the risks the company faces and the processes they have in place for assessing and managing them but some information must, for the benefit of the company and its investors, remain confidential.

Cohesive and clear narrative

13.7 Companies, especially those which are listed and applying International Financial Reporting Standards ("IFRS") are already required to provide extensive disclosures that, taken together, can provide valuable information for investors in assessing their going concern status and the liquidity and other risks they face.

13.8 However, as these disclosures are mandated by different sources the clarity of the overall narrative can be lost. Some disclosures are required to be in the directors' report, others are presented in separate corporate governance statements whilst others are included in the notes to the financial statements.

13.9 To an extent this could be addressed by requiring the collation of all relevant information in one narrative section of the annual report, but this is limited by the fact that certain disclosures must also be included in certain sections of report. A balance must be struck between the collation of information in one place and avoiding unnecessary repetition.

13.10 We would recommend that regulators, legislators and standard setters provide clearer guidance on what can be included by cross-reference to a single narrative discussion of the company's business model, the associated principal operational risks and an analysis and understanding of the financial risks arising from its investments and capital structure. We are supportive of the FRC's Cutting the Clutter project and believe that the disclosure of issues relating to going concern and liquidity risks provides an ideal case study for the development of a new integrated model of reporting.

13.11 Concerns are commonly raised on the length and complexity of these documents and their concomitant reduction in usefulness – users cannot see the wood for the trees.

13.12 In our opinion, one cause of this phenomenon is the drift over a number of years in what the annual report is expected to achieve. Whenever a new demand for information has been identified, be it on a company's internal controls, the work of corporate governance committees such as audit or remuneration or a company's societal and environmental impacts the default decision on where to provide this information has always been the same document.

13.13 Whilst considering whether any new information on going concern and liquidity risks should be added to the annual report, the FRC should also consider what could best be removed and reported through other means.

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13.14 Much of the information useful to users in assessing liquidity risk and a company's going concern status is contained in the narrative sections of the report but this is not subject to audit beyond a review that it does not contain material inconsistencies with the financial statements, which might also highlight material misstatements of fact. Given the increasing importance to stakeholders of the narrative reports we consider a review of the nature of assurance that auditors could provide is timely.

13.15 We welcome the FRC's project to stimulate debate in this area and consider it necessary that the narrative reports be subject to new audit requirements, but only if this is recognised as providing a lower level of assurance than that achievable over the financial statements and is introduced in tandem with auditor liability reform.

13.16 We would also urge further reform in the use of safe harbours for directors in the provision of forward looking information which would also be useful in assessing a company's going concern status.

Yours faithfully

PKF (UK) LLP

PKF (UK) LLP