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Dear Sirs

Sharman inquiry - call for evidence response

Grant Thornton UK LLP (Grant Thornton) welcomes the opportunity to comment on the call for evidence *Going concern and liquidity risks: Lessons for companies and auditors*.

Grant Thornton UK LLP is a leading financial and business adviser with offices in 27 locations nationwide and more than 25,000 individual and 15,000 corporate and institutional clients.

Our response is written based upon our knowledge and insight gained from our experiences in addressing issues connected with going concern during the recent financial crisis and takes into account the views of not only auditors, but also practitioners operating in a number of different areas within our firm, including technical, insolvency and restructuring, capital markets and forensic specialists.

General observations

We highlight below our general observations on the call for evidence in response to going concern and liquidity risks.

- we consider that current legislation and regulation is sufficient for companies to be able to provide appropriate disclosure on going concern and the principal risks and uncertainties to which they are exposed. Specifically we believe the guidance provided by the FRC to auditors and directors on going concern in October 2009 is still relevant and we would not wish to see its clear messages obscured by yet more disclosure requirements. We commented in our response to the Financial Reporting Council's (FRC) *Louder than Words* consultation paper and to the BIS consultation *The future of narrative reporting* that we do not advocate the creation of extensive additional layers of regulation or guidance for this reason;

- a message which we consistently hear is that annual reports are typically poorly structured and that the complexity and volume of information in the annual report tends to obscure key messages. We consider that there is a need for the voluminous elements of regulation and legislation on going concern and risk to be more coherent, by bringing together all associated disclosures on going concern and liquidity risks in one place in the annual report;

- in order for companies to report more comprehensively regarding key liquidity risks and going concern assessments, there has to be pressure from stakeholders, principally investors and key advisors. This is consistent with our comments in the FRC's consultation on *Effective Company Stewardship*. We would welcome consideration on how this can be achieved;

- we believe that attention on going concern should turn away from further layers of disclosure, which risk obscuring key information for users, towards consideration of new mechanisms for different stakeholders to address going concern (and related reporting) issues in advance of the financial statements being issued. For example, the FSA Code for enhanced dialogue between the banking supervisors and bank auditors should be a mechanism for discussing going concern pressures and the way in which these should be addressed in financial statements within the financial services sector. Attention on making such codes work effectively in practice will in our view yield better results than requirements for yet further disclosures;

- we refer to our response to the FRC's *Effective Company Stewardship* paper, which noted that directors have a responsibility both to provide appropriate, meaningful, fair and balanced reporting to investors and other stakeholders and a fiduciary duty to promote the success of the company. Clearly there is a tension in meeting both of these responsibilities and there have been examples in recent times of directors 'pushing the boundaries' in the reporting of a balanced picture. Specific areas of concern tend to focus on the reporting of the principal risks which the business faces, going concern disclosures and other forward looking statements where sometimes management put the most favourable slant on things. Grant Thornton supports the FRC's position that the directors take full responsibility for the fairness and balance of the annual report. However in making that statement we would support the publication of further best practice guidance on how directors can manage the competing demands which their duties entail;

- we consider that there is an expectation gap between the role of the auditor as set out in statute and the perception of the role by users of financial statements. The auditor's review of going concern can only provide limited assurance over the status of a company's health and is inherently less than the assurance provided over a company's balance sheet and profit or loss for the year, since the forecasts are based on numerous assumptions and uncertainties. We believe a clear articulation of this is required;

- an auditor conducts a review of going concern based upon their assessment of risk. While a more comprehensive review, akin to a working capital report for IPO requirements may provide more scrutiny, this would be a hugely expensive exercise and one in which we do not consider the benefit would outweigh the cost. Therefore we do not advocate any changes to the current auditor requirement.

Our detailed responses to each question within the consultation are set out on the following pages together with comments on other areas that we believe merit further consideration and action. If you have any questions on this response, please contact Steve Maslin (phone: 020 7728 2736; email: steve.maslin@uk.gt.com) or Martin Drew (phone: 01865 799914; email: martin.s.drew@uk.gt.com).

Yours faithfully

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Responses to consultation questions

1 What combination of information about:
• 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?

We consider that the reporting of cash flow and the robustness of the company's forecasts are the most appropriate measure for investors to assess a company's liquidity risk and its ability to remain a going concern.

We consider that there is sufficient regulation in place currently to enable a company to make full disclosure of relevant information to the market. Examples of this are the requirements in the Companies Act 2006 to disclose the principal risks and uncertainties which the company is exposed to, its financial risk management policies and objectives, the IAS 1 requirement to disclose the way in which capital is managed, the IFRS requirement to disclose key judgements and risks, the sensitivity of the key risks to a change in, for example, interest rates or currency rates and also disclosure of any uncertainties in relation to the going concern assumption. We note that the FRC's guidance *Going concern and Liquidity Risk* is a further useful tool for directors in providing appropriate disclosure.

However we believe that the clarity of message from the above requirements is often clouded by the disclosures being scattered throughout the annual report and, due to the 'clutter' which is often reported to be included in financial statements, hidden by less useful disclosures. We note also a concern over the amount of boilerplate disclosures which are presently seen in annual reports. We would welcome this area being considered further and recommend that the disclosures relating to assessing the health of a company, the key risks and the management of its working capital are collected in a more useful summary page within the financial statements.

To improve the ability of investors and key stakeholders to assess a company's ability to cope with possible changes in key risks, we consider it appropriate to enhance disclosure of the results of stress testing of key risks and variables, such as exposure to interest rate and foreign currency movements, including disclosure of the maximum sensitivity movement which the company could withstand. This disclosure would allow investors a fuller insight into the sensitivity of the company to changes in its environment.

We would also welcome further disclosure by companies of how they intend to finance their growth plans for the future. Since most of the current disclosure requirements relate to information about current capital and financing instruments within a company and the sensitivity of those instruments to change, we believe it would be beneficial to disclose additional information about facilities available to the company and whether additional debt is required for expansion plans.

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?

Listed entities are required by the market listing rules to disclose price relevant information to the market in the form of a Regulatory News Service announcement. Listed entities are also required to keep the market apprised of their financial status on a timely basis.

In practice any warning announcements on a listed entity's financial status are often only seen 'after the event', when the entity is already on the verge of insolvency. This is likely to be due to the concern that the directors have about the impact on the company's market value of making public any adverse news. For this reason we see little interaction between these requirements and the requirement to disclose principal risks and uncertainties and going concern disclosures in the interim and annual financial statements.

In the case of certain FSA-regulated entities, the auditor has a statutory duty to inform the FSA if he reasonably believes that the entity is not or may cease to be a going concern (SI2001 No.2587). However this notification is not made public.

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?

We refer to our answer to question 1 and note that there is no barrier in regulatory terms to directors making full and frank disclosures.

We consider that the biggest barrier to full disclosure is the concern which the directors have about the commercial impact of releasing negative information on liquidity risks or going concern to the market. There is a well-founded concern that making a trading statement to warn of a going concern risk could lead to panic in the market and a significant reduction in the company's value, as well as making future fundraising harder for the company to achieve. In most circumstances this deterrent prevents full disclosure by the directors until the company is in significant difficulty. We consider that there is a need for investor and stakeholder pressure on companies to ensure that earlier warnings are made to the market.

We consider that a secondary barrier to full disclosure is the absence of comparable disclosures by competitor and peer companies which act as a deterrent from being open about the risks being faced, so as to not communicate more information than other similar companies. However we recognise that this area is improving with the continued scrutiny of the Financial Reporting Review Panel.

Finally we believe it is important to appreciate that reporting requirements for directors to give meaningful disclosures are only likely to be adopted if they have an incentive to do so without the threat of unreasonable litigation. We suggested in our response to the *Louder than Words* discussion paper that more safe harbours for directors, and proportionate liability protection for auditors, may encourage better quality communication and we stress also the need for better guidance on how commercially sensitive issues should be addressed.

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?

We draw your attention to our response to question 1 and we also refer to our comments in our response to the BIS consultation *The future of narrative reporting*. We consider that the current requirements within IFRS are sufficient to enable stakeholder evaluation of a company's financial status but advocate the various disclosures being aggregated into a summary within the annual report, to provide a more coherent message.

As has been heavily publicised, we consider that currently there is too much boilerplate disclosure in annual reports of listed companies but we do not believe that this is as a result of a deficiency in the reporting regime, rather a lack of focus from directors on reporting meaningful and specific disclosures which are relevant to the company. We consider that a lack of pressure from investors over appropriate and specific financial reporting has led to apathy from many directors in providing suitable disclosure.

The issue of cutting 'clutter' is also relevant in addressing the need for appropriate reporting of liquidity risks and going concern and we welcome the work which the FRC is performing in this area with the release of its consultation on this subject. There are some wide ranging and aspirational ideas in this consultation paper, particularly with respect to presenting standing data and permanent information outside of the annual report. We look forward to seeing the results of this consultation in due course.

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, and 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?

The processes which directors undertake in making their assessment of going concern for the purposes of financial statement reporting are necessarily bespoke to each individual company and it is therefore difficult to comment in detail.

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?

The working capital report which is produced for an IPO (or alternative capital raising process) is more thorough than for an annual accounting / audit assessment as the level of assurance being provided is higher. In a capital raising process or other situation where an investment circular is issued and a public working capital statement is required, the directors are required to confirm that the company has sufficient working capital for at least the next 12 months from the appropriate date. The reporting accountant provides comfort that the directors have made their public statement after due and careful enquiry. The level of scrutiny by investors is also higher where they are committing new funds to the business. In the annual accounting and auditing assessment, the auditor is required to note only if there are any material uncertainties over the ability of the company to continue for the foreseeable future, which can be less than 12 months (though shorter assessment periods must be disclosed).

Whilst a more comprehensive review for the annual accounting or audit assessment, similar to that used for a public reporting engagement, would provide more scrutiny, there would be a huge cost burden on companies of carrying out this work every year. We do not consider that the benefit achieved from performing this work would match the additional time and cost of fulfilling it. However as stated in the response to question 1 we would urge consideration of further reporting of the results of the stress testing of key risks as part of the financial statement disclosures.

We consider that there is an expectation gap between the role of the auditor as set out in statute and the perception of the role by users of financial statements. We believe it is important that the role of auditor is clearly articulated and accepted in the market so that over-reliance on the auditor's work in respect of going concern is mitigated. We consider that the role of the auditor is not to 'flush out' when liquidity risks give rise to a going concern issue, moreover the directors have a duty to ensure that the market is kept apprised of the company's financial position and the risks to which it is exposed. We also consider that there is a need to recognise that the assurance given over going concern is inherently less than the assurance provided over a company's balance sheet and profit or loss for the year, since the forecasts are based on numerous assumptions and uncertainties.

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?

As with question 5, the answer to this question varies significantly from entity to entity and so we are unable to provide any definitive detail.

However, in our experience, most companies conduct some assessment and forecasting of future cash flows and liquidity for the purpose of identifying the potential for further investment and growth in the future. In many cases this forecasting is more often monitored for operational reasons and not for the purpose of assessing whether the business has the ability to continue in business in the future.

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

In many businesses, it is difficult to forecast more than 12 months ahead due to the uncertainty over many factors which are not within a company's control. Therefore, in our experience, whilst directors have medium to long term plans and visions, forecasting for the purpose of monitoring cash flow and liquidity risks is rarely performed for the purpose of assessing the company's viability over anything more than the foreseeable future.

9 The current model of disclosure identifies 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?

We consider that the current model of disclosures is helpful and provides a useful platform from which to consider the extent to which a company is exposed to significant going concern or liquidity risks. However, we also refer to our answer to question 1, where we suggest that disclosures could be improved by summarising all information relevant to the going concern review and liquidity risks in one place in the annual report, rather than the current status quo where different disclosures are scattered throughout the annual report and financial statements.

We consider that providing further expansion of the existing model, or additional guidance on its application, could give rise to further use of 'boilerplate' disclosures which would not be helpful. A better focussing by the directors of the existing requirements would be more helpful.

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?

The key issue, in our experience, which is present in situations of going concern problems and company failures, has been the availability of short term funding, situations where credit lines have been withdrawn from a company at relatively short notice and the lack of appropriate long term funding. In many cases, whilst the risk of financing being withdrawn is considered, it is not always identified as a principal risk in the financial statements and the disclosure of possible remedies made.

We note also that the availability of cheap finance prior to the financial crisis, and the desire for banks to lend, led to the relaxing of due diligence and covenant requirements, which previously acted as a suitable stress test for the health of the company. However, experience globally shows that easy flowing cash can be easily turned off and, in such conditions, it is critical that those in charge of governance carry out their own stress tests to see whether their company can withstand unexpected shocks.

We would welcome therefore an extension of disclosure requirements to include details of the company's future financing arrangements.

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?

In evaluating management's assessment of going concern, the auditor considers the process management followed to make its assessment, the assumptions on which the assessment is based and management's plans for future action. The auditor then considers whether the assessment has taken into account all relevant information of which he is aware.

The extent of the procedures performed to determine whether a material uncertainty exists, which may cast doubt on the entity's ability to continue as a going concern, depends on the circumstances of the entity under review. For instance, if it has a recent history of profitable operations and ready access to financial resources, detailed procedures may not be necessary for the auditor to conclude on the appropriateness of management's assessment. However, when management's assessment involves underlying assumptions regarding uncertain events or conditions, the auditor must gather sufficient appropriate audit evidence to confirm or dispel whether or not a material uncertainty exists.

These procedures may include, but are not limited to:

- inquiry of management so they may explain the key judgments and assumptions underlying their assessment;
- analysis of cash flow and other relevant forecasts, and their consistency with financing terms and available capital;
- assessing reasonableness of projections given performance history, regulatory environment, relationship with customers and suppliers, any outstanding litigation, and the sector's position in the economy, management's business plan;
- determining management's ability to forecast effectively by evaluating their accuracy through comparing past forecasts against the actual historical data it was forecasting;
- assessing how the entity has performed to date against its current budget;
- obtaining written management representations for items which are difficult to corroborate.

The auditor takes into account the results of testing of governance controls, as well as monitoring controls around the treasury function as well as the budgeting and forecasting function in the context of the appropriateness of input from the operational functions.

There are specific reporting requirements to the audit committee to include communication of the company's key issues and risks identified during the audit, the related judgments and estimates made by management, and the audit procedures which were performed for the auditor to reach an independent conclusion as to their appropriateness. If going concern is identified as one of these key areas, it would necessarily be included in the auditor's presentation to the audit committee.

The reasonableness of management's assessment can only be determined if the specific risks and uncertainties relevant to the entity's sector are considered. These may include the sector's position in the global economic environment, the extent to which it is regulated, existence of pending legislation, the significance of labour unions, circumstances of suppliers, relevance of commodity or energy prices, and relevant geo-political issues. Sector experts within the firm, or external third party sector specialists, may be consulted by the audit team.

In circumstances where there is overseas reporting, if non-UK requirements are more rigorous, the extent of additional procedures or communications that must be made to satisfy these requirements will be identified during audit planning and performed during the course of the audit. However, in our experience, overseas reporting rarely includes additional procedures.

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?

We consider that the current FRC guidance is appropriate and provides a useful platform for directors.

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

Please see the general observations which we have set out in our covering letter. In addition we also make a number of other observations below.

We welcome the comment made in the FRC's *Effective Company Stewardship* paper that no circumstances were established, in the aftermath of the recent financial crisis, to indicate that financial statements were materially misstated, rather corporate and financial reporting was overtaken by exceptional market conditions. We consider that this indicates that the UK has a well-developed and appropriate corporate reporting regime which does not require significant changes.

We refer to our response to the FRC's consultation on *Effective Company Stewardship* where we welcomed an extension of the Audit Committee's responsibilities for providing effective oversight of the company. We consider that non-executive directors have a more significant forward looking role than the auditor or the executive directors and should use the benefit of their experience to identify risks and increase the degree of robust challenge and scepticism, and to ensure that the annual report provides appropriate disclosure. We believe that more guidance is required in this area.

We note that there is little evidence of an auditor qualifying a financial institution's accounts. We consider that this is because if the auditor were to inform the company and/or the regulators that he were sufficiently concerned and was considering qualifying the institution's accounts, the company would ensure that either the accounting problems were addressed or the necessary finance was provided to remedy the deficiency.