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28 June 2011

Dear Marek Grabowski

Going concern and liquidity risks: Lessons for companies and auditors

Thank you for the opportunity to provide comments on the above consultation paper.

Responses to the consultation questions on which we are able to comment are set out below. By way of background, it is London School of Business and Finance's mission to become the first choice for business education in Europe. Through educating the world's most creative, talented and ambitious students, London School of Business and Finance aims to bridge international boundaries and provide individuals around the globe with an opportunity to achieve academic, personal and professional success. LSBF attract over 15 000 quality candidates from over 140 countries worldwide, and continues to experience exponential growth, both on-campus and online, all around the world, while continuing to develop corporate training, partnerships and associations with best-practice organisations globally.

In partnership with established and globally renowned academic partners, LSBF deliver two accredited MBA programmes and a suite of postgraduate and undergraduate business degrees (in partnership with University of Wales and Grenoble Graduate School of Business, triple accredited by AMBA, EQUIS and AACSB). LSBF is also a well established provider of professional programmes such as the ACCA, CIMA, CFA® and CIM, and operate best practices school-wide.

The school continues to expand rapidly in response to demand from UK domestic and international students for globally accredited business qualifications and currently operates four campuses across the UK; London (Holborn and Marble Arch), Birmingham and Manchester as well as international offices in Prague (Czech Republic), Toronto (Canada), Moscow (Russia), Hong Kong (China), Johannesburg (South Africa), Port Luis (Mauritius), Bogota (Colombia) and Almaty (Kazakhstan).

Independent Audit and the Going Concern Assessment: An innovative solution

We would like to suggest an innovation which would at a sweep counteract the problem of market concentration in audit.

We would propose a 'license to operate' regime that would apply to a new class of audit firms. This class would differ from that which already exists in that firms would be:-

- Outside the big 4 firms
- Explicitly be contracted on the basis of a fair and proportionate limitation of liability
- Appointed for a fixed term of, say, three years

The Financial Reporting Council would license and fund this class of firm. These firms would be licensed to audit solely the assessment of the board of directors with regard to their judgement on the going concern status of the corporations they manage. The corporations captured by this reform would be those listed on the FTSE 350 and AIM stock indices, and private firms whose size places them as medium or larger in the statutory definition of Small or Medium Enterprises.

The remit of this class of independent auditor would be two fold:-

- To answer the question, is the company a going concern for at least 12 months after the date of signing the financial statements and
- Are all relevant factors relating to the going concern assessment disclosed comprehensively and in the right place in the financial statements

The timing of the independent audit of going concern should be between the date of completion of the overall financial audit and the date of the shareholders' meeting to approve the financial statements.

The report of the independent auditor should be to the following stakeholders:-

- Shareholders
- Bond holders
- Trade creditors
- Employees
- Financial Reporting Council

Access to relevant information to audit the assessment of going concern should be via the Audit Committee where it exists, and the CFO where this does not exist.

Answers to Specific Questions posed by the Sharman Inquiry

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?

Very few disclosures outside standard corporate reporting tend to be made and so there is little interaction. There is an issue with ***placement*** *of going concern disclosure in the Annual Report – currently relevant information may crop up in a variety of places. This is not helpful for investor or analyst.*

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?

The biggest barrier is commercial confidentiality – corporations are not going to ***push*** *such information out into the public domain; it needs to be* ***pulled*** *by actively engaged investors, analysts and proactive external auditors*

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?

Bringing back prudence as a fundamental accounting concept would undoubtedly benefit corporate reporting. While shooting the messenger is too simplistic when looking at the role of IFRS's role in the recent banking crisis, there is anecdotal evidence that they have contributed to excessive market volatility, particularly in the application of 'mark to market' measurement of financial instruments. The 'Louder than Words' project aimed at simplifying financial reporting is to be welcomed and supported.

More specifically IFRS requires going concern assessment to run 12 months from last balance sheet date. UK GAAP requires assessment to run 12 months from date of signature of financial statements – up to 9 months difference. We would recommend clarification, and that the period of assessment should run from the date of signing of financial statements.

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?

Preparation of annual operating plans, reviewed six monthly; monthly update of the forward order book tested against staffing plans; rolling profit and cash flow projections and accounts; comparison actual against forecast surpluses/deficits; monitoring and acting on key performance

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ratios – debtor/creditor days; work in progress; work done to cash cycle. These are some of the processes one expects to see at a well run corporation.

• Which records and information are referred to in making this assessment?

Management accounts; cash flow - forecast and actual; credit control and invoicing; staff utilisation ratios; overhead analysis and review; project accounts on daily or other frequency; work in progress reports

• What type of model does the company use to develop scenarios to stress-test the assumptions that have been made when making this assessment?

For next 12 months: detailed cash flow and profitability forecasts
For next 5 years: summary plans covering turnover, margin, cash flow, investment, balanced by staff numbers
History: 10 year record of plan vs actual turnover, cost, margin, probable/possible workload

• What types of risks are included in the going concern assessment: financial, strategic, operational, other? How are these presented in the assessment?

Nothing routinely in the assessment – it is all down to boardroom proceedings. In the best run corporations a formal going concern assessment is not a separate activity, rather it is in the 'DNA' of corporate life

• What impact has undertaking the going concern assessment had on the planning and management of the company?

No separate impact – assessment is part of a tightening up of internal controls and attention to cash flow management- as alluded to above it is inherent in the working life of the corporation

• How has the assessment of going concern and liquidity risks been incorporated into other aspects of company stewardship and reporting?

Interestingly two notions of stewardship are raised here: stewardship of a company by its board of directors; and the stewardship of a company by its owners. The former is often neglected and would be a suitable and valuable topic for business research

• 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?

As we have noted before, and as FRC has discovered corporate reporting of the business model is at best patchy – even among those corporations that are in the vanguard of reporting. We

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would welcome the opportunity to investigate this issue more deeply and working with the FRC. We believe that a successful articulation of the corporation's business model contributes to resilience in corporate life and encourages longer term perspectives than is currently sadly the case

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?

Or indeed when conducting due diligence on an acquisition target?

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?

The best corporations will review at least monthly and, yes, be based on management accounts

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

This is an excellent question – which may be countered by asking how many directors know what their company's "natural business cycle is"?

9. The current model of disclosure identifies three categories of company[1]. 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 do not believe a third category is relevant or helpful – a corporation is a going concern or it is not

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?

A growing divergence between cumulative cash flow and cumulative declared profit
A growing amount of work done not invoiced
Cumulative invoicing falling behind cumulative costs
Increasing debtor days
Ageing debtors

[1] The disclosures in the financial statements which follow from the directors' conclusion on whether the company is a going concern identify three categories of company:

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1. Those where the use of the going concern basis of accounting is appropriate and there are no material uncertainties related to events or conditions that may cast significant doubt about the ability of the company to continue as a going concern;
2. Those where the use of the going concern basis of accounting is appropriate but there are material uncertainties related to events or conditions that may cast significant doubt about the ability of the company to continue as a going concern; and
3. Those where the going concern basis is not appropriate.

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?

We do not believe further amendments and guidance are helpful – this should be down to directors' judgement

13. Are there any other views that you would like the Panel of Inquiry to take into account?
Please see our suggestion at the head of this response.

Best regards,

Dr. Steve Priddy, Head of Technical Research