BDO

Tel: +44 (0)20 7486 5888
Fax: +44 (0)20 7487 3686
DX 9025 West End W1
www.bdo.co.uk

55 Baker Street
London W1U 7EU

Private and Confidential

By email:
sharman.secretariat@frc.org.uk

The Sharman Secretariat
c/o Financial Reporting Council
Aldwych House
71-91 Aldwych
London
WC2B 4HN

1 July 2011

Our ref: 013461/OIJ/Sharman

Direct line: 0207 893 3228
Email: david.isherwood@bdo.co.uk

Dear Mr Grabowski

BDO LLP is pleased to respond to your call for evidence regarding Going Concern and Liquidity Risks.

It is our opinion that the current guidance as published by the FRC is generally very good and, as such, a wholesale overall is not needed, and may well be detrimental. That is not to say however, that this guidance could not be further developed and we have indicated some suggestions in appendix 1.

Notwithstanding the above, it is clear that investors and other stakeholders are requesting more clear and transparent disclosures concerning such areas as key risks, liquidity risks, the business model etc. In particular many are calling for these areas to be linked together to tell a story as to the entity's susceptibility to both high frequency risks and low frequency high impact risks. Such a story would naturally include the extent to which management have stressed tested the business model.

We would also highlight that in our conversations with key stakeholders, although they are calling for better more relevant disclosures, they do not want an increase in the volume of such disclosures; they are demanding "*better, not more*"

If you would like to discuss any matter further please contact me at the above address.

Yours sincerely

BDO LLP

BDO LLP

013461/OIJ/Sharman
g:\office97\egidil\letters\sharman.doc

- Appendix 1

- RESPONSES TO SPECIFIC QUESTIONS

We have provided answers to selected specific questions below:

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?

Although there are few legal or regulatory barriers within the current reporting framework, there are significant behavioural barriers that prevent entities from providing constant and up to date information regarding their liquidity position. There is a natural concern that discussing these matters too extensively within the normal annual reporting process could risk generating a self-fulfilling cycle resulting in credit lines being withdrawn by finance providers and suppliers. Drawing attention to these matters outsides the normal reporting process is likely to be considered as only increasing the risk of this happening.

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?

In overview, the two 'reviews' are undertaken according to the same principles, however, in the case of raising capital the certainty that stakeholders demand is rightly far higher than that which they do in relation to general financial reporting. This has direct effect on the amount of work undertaken by the entity and the auditor/advisor, which in turn significantly impacts costs and fees. In theory there is no reason that such rigour could not be brought into the annual accounting process, however, this is ultimately a cost benefit question and we believe that shareholders would not support such an approach. Additionally, given this higher level of assurance needed, it is likely that there would be a significant increase in the number of companies not able to obtain a clean opinion, for example, those companies that rely on significant amounts of uncommitted funds. This in turn might alter company behaviour away from financing models that are appropriate for their business to models that "pass" the enhanced going concern review.

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 believe that the focus on the revised guidance and the desire to have financial statements containing an audit report without an emphasis of matter has had two significant behavioural effects. Firstly it has had the effect of encouraging companies to address financing and refinancing issues earlier than they perhaps would have done otherwise and secondly, to seek facilities that give them more headroom than perhaps they previously would have.

The current model has both benefits and disadvantages. It has the benefit of being conceptually simple and relatively objective, allowing stakeholders to easily benchmark where the views of management and auditors are regarding the going concern basis of preparation. This is particularly true since 2009 when the guidance was revised.

Of course, the very nature of such an approach forces a rather blunt categorisation of a situation that is frequently complex and nuanced with important facts and judgements. As such there is a risk that stakeholders treat the categorisation too dogmatically and fail to understand or take account of risks arising out of the broader business model and its interaction with the economy at large.

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?

The UK Auditing Standard ISA (UK & Ireland) 570 forms the foundation of the auditors approach to Going Concern. It is important for all to recognise that it is a fundamental responsibility of management to assess the company's ability to continue as a going concern. The Auditor's responsibility is to consider the reasonableness of this.

The way in which both management and the auditor approach their respective roles depends upon the nature and complexity of the entity, the nature and condition of its business and the environment in which it operates, and the risk which they attach to the assertion. The greater the auditor's perceived risk, the more extensive will be their work.

As such, the detail of the work performed depends very much on the facts and circumstances and therefore will rightly vary, not just industry by industry and jurisdiction by jurisdiction, but also according to the state of the overall economy and the current position in the entity's business cycle.

The auditors work often involves procedures such as examining the entity's systems and controls, challenging inputs to cashflow and financing models and challenging the degree of stress-testing performed on these models by management.

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?

The current guidance as published by the FRC has proven to be effective and in our opinion a wholesale revision is not needed and in fact may well be detrimental. That is not to say however, that further helpful guidance could not be developed. In particular, we feel that the following areas would benefit from additional guidance:

- it is essential that stakeholders understand the extent of the assessment of the going concern basis of preparation in the context of annual financial reporting and the reservations that this might have when used as an indicator of financial health. They should also understand that it is not as a robust a consideration as is undertaken for working capital review.
- The current categorisation framework includes the concept of "*material risks that may cause significant doubt*". Although integral to auditing standards, this phrase is largely absent from financial reporting standards. We believe that this phrase, which is central to the FRC guidance, should be enshrined within reporting standards.
- It is clear that stakeholders are demanding better (not more) disclosure around the way in which principle risks, liquidity risk, macroeconomic risks and he business model contribute to the going concern assessment. We believe that the FRC has a role to play in describing a framework which help preparers decide which risks to disclose and help them bring these risks together in one place to tell the going concern story.