Marek Grabowski
Director of Audit Policy
Financial Reporting Council
5th Floor, Aldwych House
71-91 Aldwych
London WC2B 4HN

26 April 2013

Dear Sir,

I am writing on behalf of the British Private Equity and Venture Capital Association ('BVCA') in response to Implementing the Recommendations of the Sharman Panel.

The BVCA is the industry body for the UK private equity and venture capital industry. With a membership of over 500 firms, the BVCA represents the vast majority of all UK based private equity firms and their advisers. This submission has been prepared by the BVCA's Legal & Technical committee, which represents the interests of BVCA members in legal, accounting and technical matters relevant to the private equity and venture capital industry.

Our members have invested £40 billion in over 5,000 UK companies over the last five years. Companies backed by UK-based private equity and venture capital firms employ over half a million people and 90% of UK investments in 2011 were directed at small and medium-sized businesses. As major investors in private companies, and some public companies, our members have an interest in financial reporting matters, the conduct and information presented by such companies, and the burdens placed on the management of such companies.

Private equity ownership involves the close alignment of interests between investors and the management of a company, and this leads to closer and often more informal relationships than between comparable forms of ownership. As such, the level of communication between these parties tends to be high, and to a level that covers the areas investors require.

In this response we have considered particularly the position of the vast majority of UK companies that are not financial services companies because we consider that the issues which gave rise to the Sharman Report related more to the financial services industry than other industries and that, in this light, it is necessary to look at the benefits and burdens of including additional requirements differently for those other industries.

Public v Private Companies

Public companies and private companies deal with their stakeholders in very different ways. Because public companies' shares are mainly listed, their communication to stakeholders on financial matters is concentrated on financial reports, regulated announcements and press releases. It is therefore important that such material has sufficient information for stakeholders to make financial decisions.

Private companies are not so restricted and tend to have a more informal relationship with their stakeholders so the benefit of requiring additional disclosure in financial reports can often be less than the burden of having to provide it.

We consider that, for both private and public companies, each disclosure proposal needs to be considered on a cost benefit basis taking into account both shareholders and other stakeholders. For private companies, the better answer on matters of going concern and liquidity is to encourage informal dialogue with all stakeholders and, for private equity, effective adherence to the Walker guidelines where applicable rather than mandating additional financial reporting requirements.

For larger private equity companies, the Walker guidelines monitored by the Guidelines Monitoring Group provide a good basis for safeguarding the interests of investors and stakeholders and these are regularly reviewed together with the compliance of the PE houses concerned which is reported on each year. We consider this to be an effective way of maintaining useful communication to stakeholders. Requirements designed by standard setters and lawmakers for public companies are considered by the Guidelines Monitoring Group when reviewing the existing Walker guidelines as part of their drive to encourage and extend best practice within private equity.

Self Fulfilling Prophesies

It is our perception that sometimes public disclosure of a risk (or risks) in a document governed by law and regulations can be misinterpreted as being more serious than it is, leading to stakeholders making decisions that increase the risk. Therefore, the mention of the risk actually contributes to a problem that might otherwise have been resolved. It is important that the right balance is achieved so as to provide meaningful transparency and clear disclosure without triggering an overreaction which could put UK companies at a competitive disadvantage.

Forward looking information

We are concerned about too much disclosure of forward looking information which we believe is, at best, uncertain and, at worst, misleading. It would seem that, for the directors' to make a positive statement about going concern, they need to have a high degree of confidence that the company will survive short term liquidity issues and longer term solvency issues. In a complex and uncertain world, we are not sure that, even if the directors' achieve a high level of confidence over the former that, given the potential risks to the latter, they would ever be able to conclude under this guidance that the company is a going concern with that high level of confidence. If the directors' are unable to make the positive statement then we consider that it will be difficult for the auditors to do anything other than emphasise this in their reports which could lead to a significant number of UK companies disclosing uncertainties over going concern compared to their overseas counterparts in a similar situation which would put UK businesses at a disadvantage.

In general, we would support additional disclosure for public companies relating to liquidity and solvency risk as long as it is useful and clear and does not, in itself, damage the commercial prospects of those companies unnecessarily. We would not support the auditors commenting on this disclosure as we think their responsibility should be to concentrate on whether the going concern basis of accounting is appropriate in accordance with accounting and auditing standards that have been set and to discuss how they reach this conclusion with management or the audit committee.

The answers to your questions are included as an Appendix to this letter.

The BVCA would of course be willing to discuss further this submission and if you wish you should contact Gurpreet Manku.

Yours faithfully

Simon Witney
Chairman, BVCA Legal and Technical Committee

Appendix

We respond to the questions you have asked below:

Question 1: Do you agree that the Guidance appropriately provides the clarification recommended by the Panel as to the purposes of the going concern assessment and reporting and is appropriate? If not, why not, and what changes should be made to the Guidance?

Although we recognise the recommendations of the Sharman Report in these proposals, we are concerned that the FRC has in a number of respects gone further and, as explained below, the proposals do not integrate well with existing requirements. This could cause confusion and would provide UK companies with different disclosure standards than their overseas competitors which could put UK companies at a disadvantage. We do not think that the proposals would be suitable or appropriate for most private companies and, in particular, would put an excessive burden on SMEs.

Question 2: Do you agree with the description in the Guidance of when a Company should be judged to be a going concern? Do you agree in particular that this should take full account of all actions (whether within or outside the normal course of business) that the board would consider taking and that would be available to it; and that, if the underlying risks were to crystallise, there should be a high level of confidence that these actions would be effective in addressing them? Is the term 'a high level of confidence' sufficiently understandable? If not, why not, and how should the description or term be modified?

We agree in principle, except for the requirement for 'a high level of confidence', particularly given the extended period upon which the judgement should be made and the economic , political and other uncertainties which are not in the control of directors' and for which it is not necessarily reasonable for the directors to have the required expertise. We are concerned that this high level of confidence might be interpreted as near certainty which would be an almost impossible hurdle. The use of any adjective here is open to interpretation but, if this is to be introduced, we would prefer the test of 'reasonable' which we believe means an appropriate conclusion, taking into account all the facts and circumstances, for which it is reasonable for directors to be able to make a judgement and over a period in which valid assumptions can be made. It not a statement that could be interpreted as almost risk free and indefinite which we fear would lead to material uncertainties having to be disclosed in the vast majority of cases.

We agree that in exercising their judgement that the directors' should take into account all actions that they might take but stress that it is likely to be difficult to assess the impacts of such actions other than over a limited period.

Question 3: Do you agree with the approach the Guidance takes to the implications and nature of actions within or outside the normal course of business? Do you consider that the Guidance explains their nature sufficiently clearly? If not, why not and what changes should be made to the Guidance?

We agree, although would be keen to see examples of what would be outside the normal course of business being those that would clearly not be considered as part of the normal course. We consider the examples in 2.14 are helpful and perhaps there should be more, but we would point out that, in the recent past, renegotiating covenants to avoid breaching them has become a more ordinary part of a financing relationship.

We are not sure whether it is intended that these types of action should be disclosed or dealt with differently as there seems to be no guidance on this.

<u>Question 4</u>: Do you agree with the approach taken to interpreting the foreseeable future and is this sufficiently clear in the Guidance? If not, why not and how should the Guidance be changed?

In establishing whether there is reasonable (and particularly a high) degree of confidence that the company is a going concern, we do not think that it is possible to forecast in detail beyond a year except to take into account further major known factors. For instance, forecasting the ability to generate enough profits to repay financing in 2-3 years time with a high degree of confidence would be challenging for many companies.

We therefore consider that matters relating to solvency beyond a year, other than those which are certain which will clearly have an impact on going concern, should be a matter for disclosure as a risk and not change whether the entity is considered a going concern or not.

In general, we believe that forward looking statements over a year should not be absolute statements but part of the directors' overall assessment of the risks to the business.

<u>Question 5</u>: Do you agree that the use of the term 'going concern' in the phrase 'going concern basis of accounting' is sufficiently clearly distinguished in the Guidance from its use in the Code requirement for a statement that the company 'is a going concern' and from its use in the accounting and auditing standards in the context of material uncertainties about the company's 'ability to continue as a going concern'? Is it clear from the Guidance that the statement the directors are required to make under the Code (that the Company is a going concern) should reflect the board's judgement and is not intended to be absolute? If not, why not and what changes should be made to the Guidance or the Code requirement?

We consider that there is a high likelihood of confusion between the two.

Directors should be encouraged to make it clear that any statement is a matter of judgement. This can be helped by making the statement in the context of risks to future solvency and liquidity rather than as an absolute statement.

We would take the view that if the directors consider the company to be a going concern then the going concern basis of accounting should be considered appropriate even though there could be material uncertainties about the company's longer term ability to be a going concern which should be disclosed. Otherwise, we could see UK companies having their audit reports modified in situations where overseas companies would not. This would put UK companies at a significant disadvantage.

We therefore consider that it should be made clear that the Guidance, Accounting Standards and Auditing Standards should be applied consistently. Otherwise we could see confusion arising.

If the directors consider the company not to be a going concern, yet they consider that the going concern basis of accounting is considered applicable because of being able to deal with short term liquidity issues, we would be concerned that, although auditors and accountants might understand the subtleties of this position, other investors, creditors and stakeholders would be confused and might act in such a way to damage the prospects of a business further.

<u>Question 6</u>: Do you agree that the judgemental approach in the Guidance to determining when there are material uncertainties to be disclosed is the appropriate interpretation of the relevant accounting standards? Do you agree that the factors and circumstances highlighted respectively in paragraphs 2.30 and 2.31 are appropriate? If not, why not and what changes should be made to the Guidance?

We suggest a clear distinction is made between material uncertainties and risks to going concern.

Material uncertainties to going concern should be based on liquidity issues over a period of a year and disclosure should be in line with that required by the relevant accounting standards so that there is clarity and consistency. We do not consider that additional guidance is required in this document.

Risks to solvency over a longer period should be a matter for the Guidance. This should not impact whether the entity accounts on a going concern basis at the time, but might be risks which impact the going concern consideration in the future. These risks are what the Guidance should require as additional disclosure.

Question 7: Do you agree that the interpretations adopted in the Guidance in implementing Recommendation 2(b) are consistent with FRS 18 and ISA (UK and Ireland) 570? If not, why not and what changes should be made to the Guidance or those standards?

No, we do not consider that a unilateral UK change to international accounting standards and auditing standards is a good idea. UK GAAP mainly affects private companies, particularly SMEs, where we consider a more informal approach is appropriate. Instead the FRC should continue to seek to influence the outcome of international deliberations at the IASB and IAASB on the basis we have set out in answer to Questions 5 and 6.

Question 8: Do you agree that Section 2 of the Guidance appropriately implements Recommendation 3? Do you agree with the approach to stress tests and the application of prudence in conducting them? Do you agree with the approach to identifying significant solvency and liquidity risks? Do you agree with the description of solvency and liquidity risks? If not, why not and what changes should be made to the Guidance?

We have concerns that an appropriate level of prudence is explained as involving weighing downside risks more heavily than upside opportunities. We see no reason why a downside risk which has an equal probability of occurring as an upside opportunity should not be considered equally. However, we agree that a degree of prudence or realism is required when assessing the probabilities. This could be explained in the Guidance as assessing risks and probabilities as objectively as possible, taking into account the degree of certainty inherent in supporting evidence by analysing the risk first and then considering how and to what extent the downside risk can be mitigated by opportunities or upside.

Question 9: Do you agree that the approach taken in Section 4 of the Guidance in implementing the disclosures in Recommendation 4 is appropriate? Is the term 'robustness of the going concern assessment process and its outcome' sufficiently clear? Do you agree that the approach the board should adopt in obtaining assurance about these matters is appropriately reflected in Section 3 of the Guidance? Do you agree that the board should set out how it has interpreted the foreseeable future for the purposes of its assessment? If not, why not and what changes should be made to the Guidance?

Subject to the comments made elsewhere in this letter, we are supportive of the additional disclosure regime recommended by the panel and the different emphasis envisaged as long as this is limited to a section of the general disclosure of risks to the business and is limited to public companies. However, we do not believe that there should be explicit conclusions in the auditor's report about the directors' going concern disclosure (see Question 10 below).

Question 10: Do you agree that the proposed amendments to the auditing standards appropriately implement the enhanced role of the auditor envisaged in Recommendations 4 and 5? If not, why not and what changes should be made to the auditing standards?

We agree that the auditor should communicate with the audit committee on its views on the going concern assessment and disclosure by directors.

We do not agree that there should be additional specific reference to going concern in the auditors' report unless the auditors wish to modify their report under present rules. We consider that the existing position is satisfactory and that to require specific disclosure would potentially add to audit costs which are not outweighed by the benefits and take attention away from the auditors' opinion on the accounts as a whole.

Question 11: Do you agree that it is appropriate for the Supplement to confirm that central bank support for a solvent and viable bank does not necessarily constitute a material uncertainty? In particular, do you agree that central bank support (including under ELA) may be regarded as in the normal course of business where the bank is judged to be solvent and viable? Do you agree that the approach set out in the Supplement to assessing whether there is a material uncertainty is appropriate and consistent with the general approach in the Guidance? If not, why not and what changes should be made to the Supplement to the Guidance?

We have no views on this matter.

Question 12: Do you consider the proposed implementation date to be appropriate? If not, why not and what date should the application date be?

We consider that entities need some time to prepare for the implementation of this guidance and that the commencement date should be after the publication of the final standard. This would allow entities, directors, audit committees and auditors to rehearse the processes privately for one set of financial reports before going public.

Question 13: Do you believe that the Guidance will deliver the intended benefits? If not, why not? Do you believe that the Guidance will give rise to additional costs or any inappropriate consequences? For example, as compared with the 2009 Guidance, do you believe that the Guidance will give rise to fewer companies being judged to be a going concern and/or more companies disclosing material uncertainties? If so, what are the key drivers and can you give an estimate or indication of the likely cost or impact? Do you believe that such additional costs or impact would be justified by the benefits?

We have concerns that the Guidance will give rise to additional costs and for fewer companies being judged as going concerns by unsecured creditors particularly in situations where secured creditors are being supportive. This, in itself, might cause secured creditors to take a different attitude in the future. We regard anything that changes behaviour to cause additional receiverships and liquidations not to be in the public interest. This has to be balanced with the benefits of disclosure. This is why we consider that the Guidance must not go too far with definitions of prudence, actions not in the ordinary course of business and the degree of confidence required. In principle we support additional disclosure but it should be balanced so as not to unnecessarily damage the entity or set up the directors as hostages to hindsight.

Question 14: Do you agree with the approach to SMEs in the Guidance? If not, why not and what changes should be made to the Guidance?

Our concerns over cost are enhanced when it comes to private companies. Here we believe there is greater danger of damage caused by disclosure because of the perceived inability to access the capital markets and reduced benefits because of the ability of stakeholders to engage in informal dialogue with entities to obtain the information they need. Therefore we consider that the application of this guidance should be to those that are required, and those that choose voluntarily, to report on how they have applied the Code only.

Question 15: Are there any other matters which the FRC should consider in relation to the Guidance and the Supplement? If so, what are they and what changes, if any, should be made to address them?

No