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30 June 2011

Dear Sir

Going concern and liquidity risks: Lessons for companies and auditors

We respond to the Call for Evidence to the Sharman Inquiry. In this covering letter, we make four major points. We have responded to the detailed questions in the Call for Evidence in the Appendix to this letter.

1. **The UK has probably the most onerous reporting regime on going concern matters in the world**

   As far as we are aware, the UK regime is more extensive than that in any other country. The UK has a longer minimum review period, being twelve months from the date of approval of the financial statements rather than twelve months from the balance sheet date as required by international accounting and auditing standards. In our experience, as evidenced in particular by our partners in our Corporate Finance Debt Advisory Group, the extended UK period means that companies are having to engage with their providers of finance perhaps two years ahead of facilities' termination dates to ensure that the directors can report positively in their going concern statements. This has a cost implication for UK companies.

   The disclosures required for listed companies by the 2009 FRC Guidance for Directors are more extensive than those required internationally. International standards require more extensive reporting only in the acute situations where, to use the jargon, there are material uncertainties and significant doubt and the auditors will be modifying their opinion. The UK Guidance requires directors to attest positively their conclusion on going concern and from 2009 to provide appropriate justification for that conclusion. The extent of explanation needed varies depending on the company's circumstances, as illustrated in the Examples 1(a), 1(b) and 2 in the 2009 FRC Guidance.

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2. Going concern and liquidity risks are financial reporting issues

Going concern is the underlying assumption in financial reporting and is recognised as such in paragraph 4.1 of the IASB's Conceptual Framework for Financial Reporting. It must be considered in preparing the financial statements and there should be appropriate disclosures. However, at present the topic of going concern is covered explicitly in only two paragraphs, 25 and 26, of IAS 1. The FRC recognised at the time of developing its 2009 Guidance that dealing with the subject outwith the financial statements was not logical. That it was so in UK annual reports was an accident of 1990s history. In 2009 the then FRC Director of Corporate Reporting therefore wrote to the IASB asking that the Board should consider the subject. As the IASB is expected to consult shortly on its agenda, we encourage the FRC to recommend to the IASB that this fundamental of financial reporting is re-examined. Assuming the IASB were to do, this may lead to consultation on the additional rules as noted in 1. above and for there to be a move to consistent international reporting.

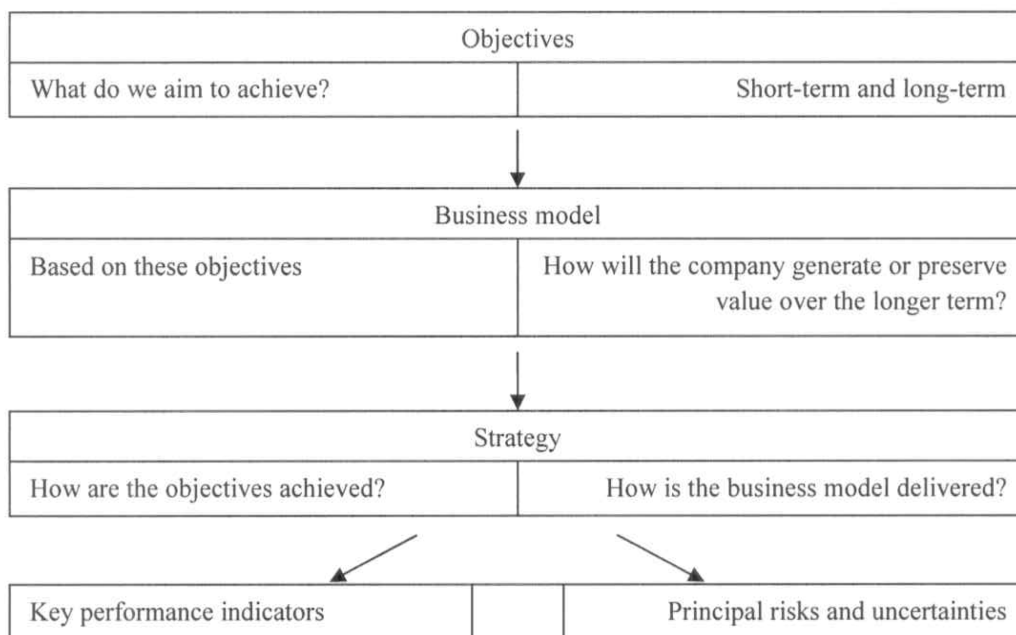
3. The 2009 FRC Guidance for Directors on going concern is working well

In our view the guidance issued by the FRC in November 2009 has been well received by investors, companies and auditors. Listed companies are now all required by the UK Listing Authority to adopt the Guidance. In our experience and based on our surveys of annual reports, companies are now getting to grips with the new regime and are providing useful going concern statements. We comment in the Appendix on detailed issues re the 2009 Guidance. The March 2011 Deloitte survey of half yearly financial reports, Six of One, showed a 95% compliance level with the guidance.

4. The topic should not be considered in splendid isolation

We believe that this topic cannot be considered in isolation from other elements of the annual and interim reports and indeed from other information sources. We refer above to an "accident of 1990s history". Rather than add this topic to the UK Accounting Standards Board's agenda in 1993/4, a separate group was established to develop guidance following the 1992 Cadbury Report on corporate governance. As that group did not have jurisdiction over the financial statements, the going concern statement was placed in the front half of the annual report. This practice of numerous groups dealing with individual elements of the annual report has resulted in the complex reporting regime for UK companies.

In our 19 October 2010 response to the Department for Business' consultation on narrative reporting we recommended that the narrative reporting rules should be streamlined and that disclosure requirements should come from one source, be based on principles and be framed in a logical and coherent manner. The chart below represents our proposed framework.



We understand that the Department will be issuing soon a further paper on narrative reporting. We recommend that the Panel seeks to integrate any proposals emanating from its work with the BIS proposals and in due course with any related international developments as referred to at 2. above.

In considering other information sources, we welcome the new FSA protocols for communication among lead supervisors, audit partners and audit committee chairs of systemically important financial institutions.

In response to your email to our Senior Partner and Chief Executive, David Sproul, we confirm that we will be pleased to assist further in the Inquiry and to meet with the Panel. Our key partners include:

- Isobel Sharp and Martyn Jones (senior technical partners, assisting audit teams in reaching conclusions)
- James Douglas (corporate finance debt advisory)
- Iain Williams (financial modelling)
- Gerry Loftus and Henry Nicholson (reorganisation services)
- Margaret Ewing (CFO community)

If you have any questions regarding our response, please contact Isobel Sharp in the first instance.

Yours faithfully

Deloitte LLP

APPENDIX

1 Transparency of going concern and liquidity risk. What combination of information about:

- **the robustness of a company's capital;**
- **the adequacy of that capital to withstand potential loses 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, which best enables investors and other stakeholders to evaluate companies' going concern and liquidity risks, is that taken from a variety of sources including Credit Rating Agencies' findings, analysts' comments and recommendations, industry analyses from informed economic commentators and of course the reports and press statements from the companies themselves. A variety of sources is generally better than just one. In our opinion, the UK market is open and information and opinions are widely available.

1.2 The annual report requirements include a statement made by directors that the business is a going concern, together with supporting assumptions or qualifications as necessary[1]; a description of the principal risks and uncertainties facing the company[2] and a description of risks relating the financial instruments, liquidity and borrowing facilities[3, 4]. These disclosures, while scattered through the front half of the annual report and the financial statements, appear to be fairly comprehensive and are being further supported from 2011 by more information on the business model[5] and financial capital management[6].

1.3 The authors of the 2009 guidance[7] recognised that while there was considerable information scattered throughout the annual report, there was not a clear statement explaining the directors' view on going concern. The 1994 Guidance resulted in a boilerplate paragraph. Thus the aim of the 2009 Guidance was inter alia to pull together the scattered references in the opening paragraph of the going concern statement and to add a paragraph or more explaining the directors' view before the final boilerplate concluding paragraph. The possible content of the middle paragraph(s) is illustrated in the Examples in the 2009 Guidance.

1.4 The 2009 Guidance is already more extensive than any other international guidance, both in terms of period of review and level of disclosure required.

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[1] Listing Rules 9.8.6R(3)

[2] CA2006 Section 417 (3)(b)

[3] IFRS7 paragraphs 31-42 risks arising from financial instruments, 50a undrawn borrowing facilities and covenant requirements, 18-19 covenant breaches, 125-133 sources of estimation uncertainty

[4] FRS29 (where adopted) 31-42 risks arising from financial instruments, 18-19 covenant breaches; FRS13 40 (for those not adopting FRS26) requirement to disclose the maturities of material undrawn committed borrowing facilities, FRS18 50-55 and 57 sources of estimation uncertainty

[5] UK Corporate Governance Code provision C.1.2

[6] ASB Financial Capital Management Disclosures December 2010

[7] The 2009 Guidance referred to throughout this letter is the Financial Reporting Council's Going Concern and Liquidity Risk: Guidance for Directors of UK Companies 2009

Period of review

1.5 UK companies are required to look ahead at least twelve months from the date of approval of the financial statements. Non-UK companies reporting under IFRS[8] consider at least twelve months from the balance sheet date.

UK Disclosures

1.6 Under the Listing Rules UK companies are required to make a statement that the business is a going concern with supporting assumptions and disclosures as necessary in accordance with the Guidance. This exceeds disclosure requirements under IAS1:25[9] where disclosures are only given where there are material uncertainties and significant doubt.

1.7 Our surveys[10] have reviewed the application of the Listing Rules from 2008/09 to the half year reporting cycle 2010/11. Our survey results on the 2010/11 reporting season will be available in late September.

1.8 The results in the surveys show the increasing application of the 2009 Guidance. Over the same period emphasis of matter paragraphs, i.e. cases in which where are material uncertainties and significant doubt, have decreased from seven in 2008/09, six by half year 2009/10, four in annual 2009/10 reports and none in 2010/11 half year reports.

1.9 Figure 1 below illustrates that the number of listed companies with significant uncertainties has declined from 2009/10 to 2010/11 and that 95% of such companies are commenting on going concern in their half-yearly financial reports.

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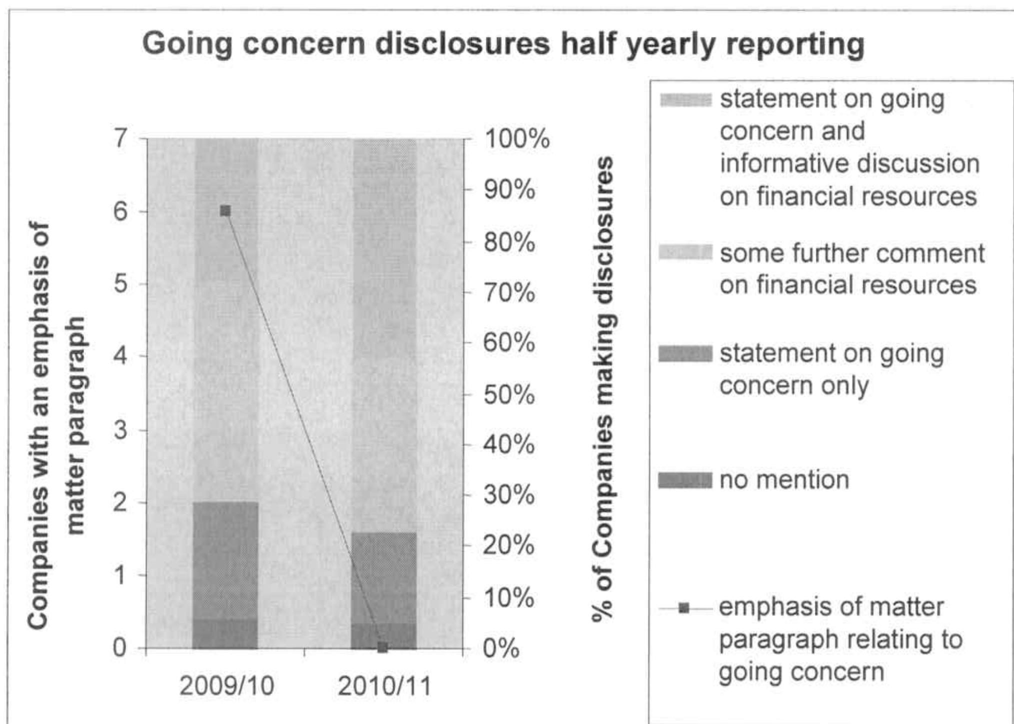
[8] IAS 1: 26

[9] "when management is aware, in making its assessment, of material uncertainties related to events and conditions that may cast significant doubt upon the entity's ability to continue as a going concern, the entity shall disclose those uncertainties"

[10] Deloitte surveys include "Drowning by Numbers surveying financial statements in annual reports" (2009/10 reporting season) "Swimming in Words surveying narrative reporting in annual reports" (2009/10 reporting season) and "Six of One surveying half yearly financial reporting" (2010/11 half year reports)

Figure 1: Going concern disclosure half yearly reporting[11]



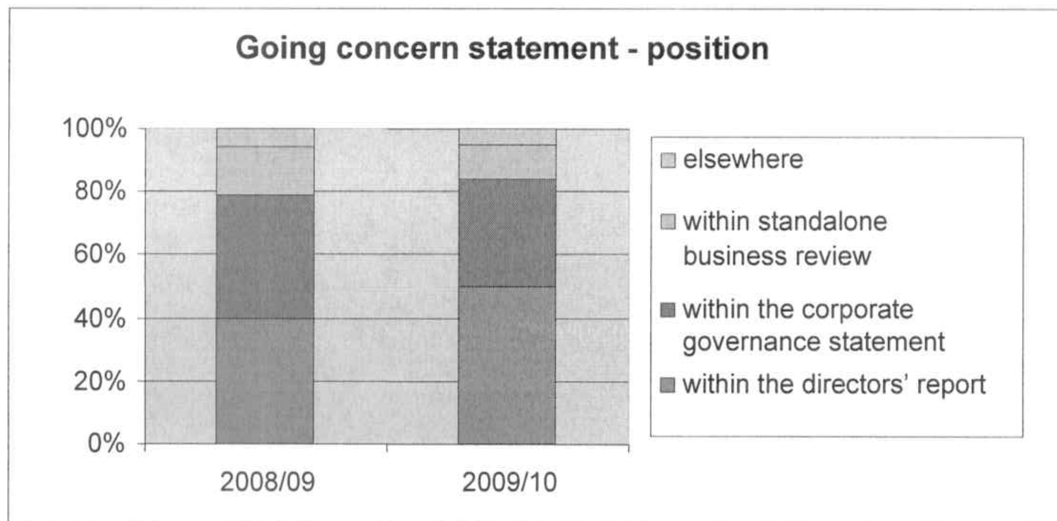
1.10 The relevant disclosures fall into a wide range of prescribed disclosures, including liquidity risk, financing arrangements and uncertainties posed by economic outlook or business plans. The reader may have found it difficult to identify the significant facts as they are dispersed. The 2009 Guidance recognised the accumulative nature of the going concern evidence and recommended that all disclosures be brought together in one place[12].

1.11 From the results of the Deloitte 2010 survey, there is considerable variation in placement, contents and amount of cross-referencing provided to other parts of the financial statements. Figure 2 below illustrates that finding the going concern statement required by the 2009 Guidance can be difficult. We comment under Question 4 below on the potential solution.

[11] Information taken from Deloitte survey "Six of One surveying half yearly financial reporting"

[12] The Guidance (para 80): It is helpful to investors and other stakeholders if all of these disclosures are brought together in one place in the company's financial statements. It may be necessary to provide a cross reference to that single place from other parts of the annual report. If it is not practicable to provide all of the information in a single place it is still helpful if the key disclosures are brought together by way of a note that includes appropriate cross references to information in the financial statements and from the financial statements to information included elsewhere in the annual report.

Figure 2: Position of the going concern statement[13]



1.12 The following extract was repeated in full five times in one Annual Report, being twice in the Directors' report and once in the group accounting policies, the note on financial liabilities and the individual company accounting policies. This is not a criticism of the company concerned but a comment on how rules have grown like topsy in the UK.

> The Group closely monitors and manages its liquidity risk. Cash forecasts are regularly produced and sensitivities run.
>
> After taking account of the above, the Directors have a reasonable expectation that the Group has adequate resources to continue in operational existence for the foreseeable future. Accordingly, they continue to adopt the going concern basis in

1.13 Our research[14] shows that with the 2009 Guidance coming into effect, companies are reporting effectively in their going concern statements. The 2009 Guidance's Examples have proven particularly helpful. Companies with few or no going concern issues follow the style of Example 1(a). Those with some exposure use Example 2 and provide a more fulsome explanation.

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 Disclosures outside the annual and interim reporting cycle with particular relevance to going concern are in listing applications and profit warnings. Both of these are dictated by circumstances and in the case of a listing application by a large body of requirements. As a

[13] Information taken from Deloitte survey "Swimming in Words Surveying narrative reporting in annual reports"

[14] Deloitte survey "Swimming in Words Surveying narrative reporting in annual reports"

result there does not appear a need for additional guidance. Working capital requirements are discussed in further detail in our response to Question 6.

2.2 We have discussed above half yearly financial reports. UK listed companies are also now required to issue Interim Management Statements, reporting approximately on the first and third quarters of the year. In 2010 Deloitte reviewed IMSs[15] issued for the third quarter. 29% of companies provided information on their financial position such as:

> "[X]'s financial position remains strong and the Group's cash balances are tracking management's plan for the year".

2.3 With the IMS, the half-yearly financial report, the preliminary announcement and the annual report, companies are updating routinely the market. We note that practice around the IMSs varies widely but there is more conformity around IMSs from investment trusts. We believe that this is partly due to the Association of Investment Companies producing in 2007 technical guidance on IMSs for its members. The Financial Reporting Council may wish to carry out research on these reports and to determine whether publishing the findings of this research would encourage improvements in IMSs by corporates.

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 In the covering letter we refer to the UK having probably the most onerous regime on going concern matters in the world. We refer above to companies complying with the 2009 Guidance.

3.2 We acknowledge that there are fears that discussing too extensively going concern and liquidity risks would generate the self-fulfilling prophecy with banks withdrawing facilities and suppliers withdrawing credit if they read too much about such risks.

3.3 While listed companies seem comfortable with the current regime more support is required for those smaller companies who are more vulnerable to a single funder/source of finance. Changes to address this perceived fear could come from the banks and credit rating agencies issuing an open statement that absence of comment raises more questions over going concern as the rigour, responsiveness and diligence of the directors in applying the 2009 Guidance is not demonstrated.

4 Given the current measurement, recognition and disclosure requirements of International Financial Reporting Standards (IFRS), how effective are IFRS financial statement in enabling stakeholders to evaluate the robustness of the 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 IFRS demands a considerable number of detailed disclosures and in particular IFRS 7 requires extensive information on the nature and extent of risks arising from financial instruments.

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[15] Deloitte survey And there's more "Surveying second halves' interim management statements"

IAS 1 provides for disclosure of information on capital and its management. But on going concern IFRS says little (there are only two paragraphs in IAS 1) and on business risks there are no direct requirements.

4.2 As we note in our covering letter, we believe that the IASB should examine the topic with the aim in part of introducing the going concern statement as illustrated in the Examples in the 2009 Guidance. We recommend a top-down approach rather than adding more detailed pieces of data in the notes to the financial statements. International competitiveness is important to UK companies and non UK companies providing information of a similar nature to that provided by UK companies will presumably be valued by investors.

4.3 The IASB is expected to consult shortly on its agenda. We recommend that the FRC asks that going concern be added to its agenda. In the event that the IASB produces guidance, the UK could remove the 2009 Guidance and going concern disclosures could be found consistently in financial statements. This could solve the scatter problem, referred to at 1.11 to 1.12 above, currently found in UK annual reports.

5 Company assessment of going concern and liquidity risk. 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 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 the 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 processes undertaken by directors have extended considerably both in the rigour of the process and in its frequency since October 2008. The nature and timing clearly depends on the company's financial position, ranging from audit committees routinely requiring a paper to support the disclosures made in the financial reports to the topic being covered at every board meeting. Many models are tested for sensitivity to the major assumptions.

5.2 There has also been a significant step change in the due diligence and forensic examination undertaken by the banks prior to financing or re-financing. This is resulting in more developed financial models and cash flow forecasts being used by companies.

5.3 However, we note from our contacts with companies aiming to raise debt (both in normal and distressed circumstances) that many do not have fully integrated financial models and this is an area for internal improvement.

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 annual accounting or audit assessments?

6.1 In a public offering scenario, there are a number of regulations and guidance[16] aimed at EU issuers requiring specific positive and unequivocal statements on going concern ("working capital statements") and the basis for making them. CESR guidance makes clear that it is unacceptable to detract from the value of the positive statement by the stating of assumptions or the use of caveats.

6.2 To support a working capital statement issuers are expected to have:

- prepared unpublished supporting prospective financial information in the form of internally consistent cash flow, profit and loss and balance sheet information;
- a business analysis covering both the cash flows of the business and the terms and conditions of commercial considerations associated with banking and other financing relationships;
- consideration of the strategy and plans of the business and the related implementation risks together with checks against external evidence and opinion; and
- an assessment of whether there is sufficient margin or headroom to cover the reasonable worst case scenarios (sensitivity analysis).

6.3 Whilst working capital statements require a higher level of assurance the materials prepared by the directors to support the ongoing cash flows and management of the business may not be substantially different. The difference comes in the need to unpick to the lowest business unit and to test assumptions with more extreme probabilities. In addition there is a very specific difference over the level of committed financing arrangements in place. A working capital statement will require a direct confirmation with the bank of existing and future facilities and that confirmation would expect to cover a much longer period than that typically considered in a going concern review.

6.4 Thus a working capital review requires committed facilities for what is effectively a 22 month period from the date of the offering. A going concern review instead focuses on whether facilities are likely to be available, based on past and current information, looking forward approximately 15 months for a listed company and potentially longer for a smaller company that does not prepare its accounts so close to the balance sheet date.

6.5 Should the directors in a working capital statement suggest, as in the 2009 Guidance, that "they have a reasonable expectation that the company has adequate resources to continue in operational existence for the foreseeable future"[17] these words would almost certainly be taken as a caveat and rejected as inappropriate.

6.6 These differences give a higher level of assurance but also result in higher costs to the business both of audit and, more significantly, in terms of banking and arrangement fees to ensure that committed facilities are in place.

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[16] The Prospectus Rules and CESR (now renamed EMSA) offer detailed and specific guidance.

[17] 2009 Guidance Appendix II example 1(a)

6.7 No procedures can guarantee business success or identify business failure. Any additional procedures have to be assessed in light of their cost to business and benefit to the user. Furthermore going concern risk cannot be eliminated as it is simly part of doing business.

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 From our listed company audit experience cash flows are reviewed as part of the directors' processes as a minimum in line with planning and budgeting, interim and final reporting cycles. In addition, some companies are now also looking at crunch points during the monthly cycle as well as at the month end. However as discussed under Question 5 there is still scope for companies to improve their business and financial modelling.

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

8.1 While we have referred above to specific time periods, the accounting and auditing standards and the 2009 Guidance are very clear that this is a minimum. All available information about the future must be considered. Thus viability over business cycles must be considered if these give cause for concern in the medium term.

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 model be helpful?

9.1 The conclusions of the model are and remain relatively simple[18] with the advantage that boundaries and categorisation are clear. The most significant changes between the 1994 guidance and that in 2009 were not the number of categories but the disclosures required by the directors to support the categorisation. To assist directors Appendix II contains Examples 1(a) and (b) and 2 for no significant doubt and Example 3 for a company with significant doubt. The wording in the first set of Examples illustrates a range of scenarios. We believe that it would be wrong to characterise the model as a simple three box approach but acknowledge that more could be done, perhaps by reviews of practice, to illustrate the variety in reporting needed to meet individual company circumstances.

9.2 The model drives the directors to focus on the uncertainties inherent in the business and its plans and assumptions. This drives potentially a better understanding of the business. However, as the 2009 Guidance states, "the process carried out by the directors should be proportionate in nature and depth depending upon the size, level of financial risk and complexity of the company and its operations".

9.3 Following publication of the 2009 Guidance, we have provided more guidance to our people,

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1. No material uncertainties that may cast significant doubt about the company's ability to continue as a going concern;
2. Material uncertainties related to events or conditions that may cast significant doubt ...but going concern remains appropriate;
3. The use of the going concern basis is not appropriate

being Q&As on a number of different circumstances. We are happy to provide this separately to the secretariat to illustrate areas on which further guidance may be needed.

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 The economic circumstances of 2008 onwards highlighted the focus on going concern and the need for reporting to both bring together disclosures already made in the financial statements, for example of liquidity risk and maturity of assets.

10.2 The corporate collapses of this period potentially illustrated more misunderstanding or miscommunication of the business model and thus a failure to understand the systemic impact of the collapse of a part of the market. The changes incorporated in the 2010 UK Corporate Governance Code seek to remedy these omissions.

10.3 Since 2009, the overall economic environment has steadied on and, as shown above, the number of companies surveyed with significant going uncertainties has declined.

11 The auditors approach to going concern and liquidity risk. 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 audit approach is in accordance with ISA (UK and Ireland) 570. Risks are identified as part of the planning process and those risks which may give rise to a going concern risk will be considered separately.

11.2 The auditors' approach is to review and challenge the information used and assessed by the directors. The auditors can add value to the audit through this challenge, particularly through testing of the sensitivity analyses and assumptions used by the directors in their modelling.

11.3 The approach and processes used by the auditors will be similar regardless of industry. However the information that is critical to the business and subject to that review will vary. The depth of any review is likely to be influenced by the headroom available to the company.

11.4 From an internal review of a sample of reports to Audit Committees of FTSE companies for 2010 accounts 81% of reports include detailed discussion of going concern, a forceful indicator of the considerable attention to the issue within listed companies. All the companies reviewed gave disclosure in their annual accounts and no company had an emphasis of matter paragraph.

11.5 Each industry sector will have specific risks and concerns that will by necessity focus the going concern review.

11.6 The FSA Code of Practice for the relationship between the external auditor and the supervisor published in February 2011 aims to ensure through planned meetings that there is communication between the auditor and regulator. The Guidance Consultation "Market and

regulatory failures, benefits and costs" encourages these meetings to put the regulator in a more informed position, as it states "from a regulatory capital point of view it may be necessary to take a more prudent view than that required under accounting standards (e.g. IFRS or UK GAAP). Supervisory experience suggests that more formal interaction and information sharing with firms' auditors could improve our ability to evaluate the risks to our objectives".

11.7 Our audit approach does not vary by location as we report under ISA (UK and Ireland) for UK companies.

12 Feedback on the Guidance for Directors of UK Companies in respect of going concern and liquidity risk. 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 As covered in our comments above, the 2009 Guidance is clear and goes beyond current international guidance. In our view, it is working well and is not in need of immediate amendment. As noted in our covering letter and in responding to Question 4, we believe that the FRC should aim for international adoption of the key elements in its 2009 Guidance by asking the IASB to add this topic to its agenda.

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

13.1 Our principal views are included in our covering letter.