Barclays Corporate
Submission of Evidence to Sharman Inquiry on Going Concern and Liquidity Risk

Executive summary

Barclays is pleased to submit a response to the Financial Reporting Council's Sharman Inquiry on Going Concern and Liquidity Risk.

Barclays is responding to the specific questions contained in an email dated 31 May 2011 requesting views from the perspective of our loan work-out teams, the full details of which are detailed in Appendix 1 attached.

Our observations are based on our own experiences and insights built up over many years of practical experience in loan work-out. Within Barclays this is conducted through our dedicated specialist "Business Support" teams which sit within our risk management function.

In our experience there are a number of critical factors that help support a rescue culture and in turn increase the chances of delivering a successful restructuring solution. Firstly, early engagement within Barclays to our Business Support team, which is an experienced team specialising in corporate stress and turnaround. The team has access, though their market contacts, to specialist external advisors and interim management teams who can provide additional help to incumbent management who can be inexperienced in dealing with an underperforming business which is displaying characteristics of financial distress.

Secondly, there must be a viable business, often contained within a larger business experiencing financial or operational stress, capable of being turned around.

Thirdly, there must be a capable management team who not only recognise the issues and are willing to respond appropriately, but are also sufficiently skilled and experienced to deliver the turnaround.

Finally, there needs to be a willingness by the financial stakeholder group to provide appropriate ongoing support in the right way with aligned interests to create a stable platform for the business turnaround.

Typically all of these elements would need to be in place to ensure success. Taken in isolation these factors mean the chances of success, whilst not impossible, place additional execution risk on a successful turnaround.

Barclays recognises the importance of all of these critical success factors and as such has an early engagement model which acts as a catalyst for change with management. Barclays has an experienced team capable of communicating key messages in the right way with confidence to not only support viable businesses through their difficulties but also to appropriately influence other key financial stakeholders to adopt this supportive approach. Barclays also has access, through established market contacts and industry bodies, to provide appropriate external professional advisor input and access to interim or executive management providers to support incumbent management teams.

Barclays believes this is a successful model for supporting the UK rescue culture and playing a lead role in this market.

Introductory remarks

Companies experience financial distress for wide ranging reasons. From short term cyclical downturns and company specific operational factors through to longer term structural dynamics including industry life cycle changes where companies have been slow to respond or have weak, failing, inappropriate or poorly executed strategies or business models.

Companies with conservative business models, whether financial or operational, usually have more options and often more time to adjust to adverse changes when compared to more aggressively geared businesses with little or no operational and financial flexibility to cushion downturns in markets and company performance.

Management is a key driver to historic and current circumstances and in delivering a successful solution. Early recognition of the issues, magnitude and time criticality are important. So too is a decisive approach to deliver proportionate actions to turnaround the company. Management skills set to "run for growth" or an acquisitive merger and acquisition mandate can contrast quite markedly with a "run for cash" and cost cutting restructuring agenda which is why one often sees either additions or changes to incumbent management in order to deliver a successful turnaround.

In most of our relationships with clients there is frequent engagement and dialogue. We also use supporting financial information or account behavioural tools that enable us to have a dynamic early engagement model with our Business Support teams. This approach has been successfully built up over a number of years and is culturally and procedurally embedded within both Barclays Corporate and Barclays Business. Inevitably though, usually driven by client approach and behaviour, we occasionally experience exceptions to this preferred model.

Frequency of engagement and information flows depends upon business segmentation and client sophistication, complexity and debt levels, and ranges from frequent (daily or weekly) flows with some receivables financing facilities and account behavioural tools, through to less frequent annual reviews for longer term simple vanilla debt structures.

Typically though, this would generally fall into either monthly or quarterly information flows or engagement for the majority of our client debt portfolio.

Comments in response to: "The factors that give rise to entities' loans being transferred into work-out or similar special recovery or monitoring teams"

Observations

1.0 We have a framework model for referral into our Business Support function driven from account behavioural activity, analysis of company specific management information and trends and market or sector related activity or events. This can often be inter-dependant.

1.1 All of the following features-, individually or collectively, would be warning signs for referral into our Business Support teams:

Account behaviour

1.2 Adverse account behaviour activity including increased account hard-core debt, deteriorating month on month trends, falling turnover, unauthorised account excesses, unpaid items, loan payments missed or dormant account activity.

1.3 Request to restructure existing debt obligations. Frequent funding requests often at short notice or of urgent nature not supported by normal commercial reasons.

1.4 Requests to defer, reduce, or cancel existing debt amortisation payments.

Company performance

1.5 Unexplained or material deterioration in financial performance compared to budget and/or prior year. This would be tested regularly through receipt of company Management Information with the frequency varying between monthly to annual tests dependent upon borrower sophistication, debt quantum and complexity. Typically tolerance thresholds for referral into Business Support are set c. 10-20% below the company plan depending upon the financial cushion within the business. This threshold is set above covenant and / or payment default thresholds thus giving more time for Business Support engagement ahead of covenant breach or payment default occurring.

1.6 Financial performance may include one or more of the following metrics: falling sales, lower gross margins, increased costs, reduced profits / trading losses, reduced or negative cashflow, material or frequent exceptional charges.

1.7 Unexplained or unusual trends in balance sheet information including build up in stock / WIP with slower stock turn possibly masking obsolescence; build up in debtors with slower debtor turn possibly masking bad or doubtful debts or debtors in dispute through to performance related issues; build up in creditors with slower creditor days possibly masking liquidity issues with unsustainable creditor stretch; unusual accruals; contingent liabilities changes; inappropriate depreciation policy for assets or sector; unusual provisions releases against assets; term debt becoming due within current year, material changes to off balance sheet items.

1.8 Mismatches or unexplained variations between profit and cash which can result from an aggressive accounting policy in treatment of revenue recognition and /or capitalisation treatment on balance sheet verses accrued cost through profit and loss account.

1.9 Covenant breaches or requests to amend or reset existing covenant terms and testing dates without sufficient commercial justification.

1.10 Change in company year end and / or change in company auditors without sufficient explanation.

1.11 Deteriorating working capital and reduced liquidity headroom. Adverse changes to companies' terms of trade, either shorter credit periods granted by suppliers or longer creditor periods sought by customers. HMRC arrears or "Time to Pay" arrangements in place. Trade insurance limits removed or reduced.

1.12 Failure of major customers leading to deterioration in debtor collections and increasing bad debts and loss of ongoing revenue and profit. Failure of a major supplier impacting adversely on the companies business model and product offering.

1.13 Loss of the support of a key financial stakeholder or withdrawal of previously committed funding lines that cause a liquidity issue within the company.

1.14 Poor quality management reporting, restatement of financial information or discrepancies between audited and management information are reflective of underlying issues with management ability or integrity.

1.15 Onerous contractual obligations or contract underperformance leading to funding gaps. Significant or unexpected unfunded contingent liabilities.

Market & sector related events

1.16 Sudden or unexpected profit warnings or revised earnings guidance issued to the market without banks prior knowledge or satisfactory explanation.

1.17 Unplanned or unexpected changes to management teams particularly if executed at short notice and again without banks prior knowledge or satisfactory explanation.

1.18 Failure of a major customer through to systemic shock in a key market leading to temporary or permanent disruption of the market e.g. Icelandic banking crisis with some of our multi lender situations.

1.19 Sector wide events causing temporary disruption or suspension of business activities e.g. foot and mouth and support given to agricultural sector; volcanic ash disruption to aviation market ; 7th July London Bombings disrupting London retail and hotels sector; collapse in housing market and impact on UK house builders in 2008.

Comments in response to: "The early warning signals that as a lender you monitor and/or are alert to and that, if present either alone or in conjunction with other factors, would typically cause you to question the sustainability of the loan facilities for the entity and the recovery of the amounts outstanding"

Observations

2.0 Many of the features we have detailed above, which are early warning signs for referral into our Business Support teams, may continue to feature here in this chronology.

2.1 Factors which may cause us to question the sustainability of the loan facilities may be influenced by any new adverse information flows coming out once the company is within our Business Support team. How the management team choose to react to the company's situation and how the other stakeholders collectively and individually also respond to supporting the turnaround process may also cause us to question this.

2.2 Specifically what tends to be seen at this stage includes the following:

Account behaviour

2.3 The features described above becoming more pronounced with more frequent excesses, unpaid items, loan payment default, declining turnover.

Company performance

2.4 Late receipt of management information and overdue audited information.

2.5 Independent review of financial information uncovering black holes.

2.6 Constant revisiting or refreshing of company produced forecasts often linked to a downward revision of the numbers which may indicate a worsening or rapid pace of decline within the business, inadequate financial capability within the financing function or lack of management control over the business.

2.7 Revisiting, through a bottom up process, company forecasts and budgets identifying overly optimistic assumptions and downward sensitivity in profitability, often linked to removal of forecast cash headroom and / or additional funding requirement.

2.8 Independent verification of asset valuations identifying need for additional provisioning or downward revision of collateral and/or lender security position.

2.9 Review of security identifying security imperfections with remediation activity requirements.

2.10 Breach in financial covenants with lenders reserving their rights pending a commercial consensual solution being found.

2.11 Temporary suspension of debt amortisation payments or capital repayment holiday requests or in more extreme cases inability to meet interest payment obligations.

2.12 Qualified audit reports, going concern and emphasis of matter reporting.

2.13 Progressive build up in creditor stretch with suppliers putting goods on slow or stop and / or reverting to cash on delivery.

2.14 Inability to meet HMRC "Time to Pay" arrangements or requests to be included on TTP being declined. Trade insurance limits removed or reduced.

2.15 Management not taking appropriate decisive action often with absence of, or declining, any advisory input to help support them through what is often unfamiliar territory for them.

2.16 Sudden or additional management resignations.

2.17 Key people leaving the business. This is particularly the case in 'people businesses' where personnel provide the intellectual capital of the company.

Market and Sector related events

2.18 Deteriorating assets values through glut of supply or lack of demand and consequential impact on lenders loan to value ratios.

2.19 Adverse publicly available information ranging from credit rating downgrades or watch notices issued through to published debt information and court actions such as winding up petitions.

2.20 In relation to publicly quoted businesses, unexpected significant adverse movements in share price and adverse trading announcements or market updates.

2.21 Adverse press comment with names in the public domain creating a de-stabilising influence in the external marketplace undermining the restructuring process and confidence in the sustainability of the company.

Comments in response to: "The factors, whether behavioural or otherwise, that in your experience are more likely to lead to a successful turnaround or that are more likely to result in the insolvency of the entity or a major curtailment of its activities"

Observations

3.0 Successful turnarounds are characterised by the existence of a core viable business (which can often be captured within a larger business in financial distress) and delivered through a management team with the capability to execute a turnaround plan with access to the necessary ongoing funding, time available to deliver the plan and ongoing support of all or the majority of existing key stakeholders.

3.1 Early recognition of issues which give more time to deliver a consensual solution and decisive management action to execute the financial and operational turnaround are key ingredients of success.

3.2 Conversely late recognition of issues, management in denial or late or inappropriate action and failure to secure a stable platform through key stakeholder support for the turnaround are all likely to increase the risk of failure.

Influencers of success:

3.3 The willingness of key stakeholders to work together to find a consensual solution and where necessary enter into standstill arrangements (formal & informal) or temporarily suspend rights of action arising from default.

3.4 The attitude of trade creditors, credit insurers and the crown creditor towards providing support continuity of supply and credit lines.

3.5 The gearing / debt burden affects the level of change that needs to be made and may render a turnaround impossible.

3.6 The availability of additional funding, be it from internal sources (asset realisations, directors, shareholders, family) or external sources (banks, regional funds, other financial providers) will often be affected by the availability of assets and collateral.

3.7 Early recognition and acceptance by management of business underperformance and the need for change. How quickly management moves through the denial curve.

3.8 Early engagement with and full disclosure to lenders and advisors.

3.9 Focus on cash management or cashflow forecasting and real time management of short term cashflow & updating forecasts.

3.10 Willingness to engage expert third parties - both business and stakeholders - often require quality external advisors to support a successful turnaround.

3.11 Management ability to take prompt, effective corrective action at pace with appropriate resource allocation. Willingness to make management change / seek management support involving turnaround / or impose interim management such as a chief restructuring officer and similar roles.

3.12 Integrity of management and willingness to compromise on salary or dividends.

3.13 Quality and robustness of turnaround plan and frequency of management information available to enable monitoring of plan.

3.14 The potential stigma attached to an insolvency process as part of a solution. In certain circumstances an insolvency process can prove the most effective method to restructure the liabilities of the business and ensure that the core viable business is placed on a sound financial footing. Negative market, supplier, or press attitudes to insolvency processes potentially place at risk viability of the ongoing business.

3.15 The ability to keep high profile situations out of the public domain thus avoiding third party and market speculation which has the potential to undermine the company's turnaround prospects.

Comments in response to: "Your views about the transparent and timely reporting of going concern and liquidity risk in financial statements and audit reports where entities are facing financial distress (see questions 1 to 4)"

4.0 Whilst audited accounts form a part of information reporting requested by a Bank, the closer relationship typically enjoyed between Bank and Customer coupled with the additional information / disclosure requirements in debt documents result in limited additional value from going concern or liquidity reporting. As abbreviated accounts have no profit & loss or cashflow statement they add little or no value to our analysis.

4.1 Audited financial information is historic and the Bank will typically have had access to management information / forecasts that have already alerted it to going concern and liquidity risks resulting in the engagement of Business Support. Audited accounts received 10 months after year end have been superseded.

4.2 Management are often so concerned about negative market perception (customer / competitor / trade credit / equity markets) of any emphasis on matter or going concern disclosure that they will work with the auditor to produce evidence or revised forecasts to seek to mitigate or eliminate disclosures.

4.3 The wording of any disclosure is typically heavily negotiated between management and the auditor resulting in significant variation in quality of reporting.

Comments in response to: "Your views, to the extent you feel able to comment, about the issues raised in the remaining questions - question 12 seeks views about the FRC's guidance and question 13 is more general in nature. The other questions seek views about the actual practice of companies and auditors in assessing going concern and liquidity risk. If you are unable to respond to these questions from your experience, your views as to your expectations of companies and their auditors in relation to the matters raised would be very helpful."

5.0 We have commented by exception on the remaining questions. Our comments below span a number of the questions raised. The comments are naturally informed by the closer relationship typically experienced between Bank & Customer and the additional information we have access to.

Comments in response to: Question 1

6.0 Disclosure regarding trading terms and performance against terms along with overdue creditor positions such as HMRC time to pay arrangements in audited accounts, would provide useful additional information. This needs to be balanced against the risks of negative trade credit or market reaction destabilising a fragile business.

6.1 Similarly increased disclosure about covenant performance or headroom and impending breaches would increase disclosure. The negative consequences of disclosure should be considered.

Comments in response to: Question 5

7.0 The existence and quality of financial models varies significantly. Again typically larger businesses with some independent management are more likely to have models / forecasts and use them as management tools. Our experience of stress testing is that this is done on a limited basis.

Comments in response to: Question 7

8.0 The comments above (question 5) apply particularly to the use of cashflow and liquidity forecasting tools and frequency of review. More experienced management teams, particularly in stressed / distressed situations will typically be managing cashflow / liquidity forecasts more frequently.

Comments in response to: Question 8

9.0 In our experience very few management teams assess the viability of the business through the business cycle. Forecasting tends to be completed on a short or medium term basis and informed by current economic conditions and forecast.

Comments in response to: Question 12

10.0 There is generally limited training available to Directors before they take office and in relation to appreciation of going concern or liquidity and capital base risks our experience is this varies wildly. Typically, although not always the case, the involvement of independent professional directors, executive and non-executive, improves the quality of risk management.

Comments in response to: Question 13

11.0 Directors are often reluctant to publicise or disclose adverse information promptly due to potential consequences for them personally (job security / equity market reaction / personal wealth) and stakeholder support.

11.1 Up to the point they become exposed to personal liability arising from wrongful trading there are limited consequences for directors arising from non-disclosure. Personal liability risk typically has a marked effect on management behaviour and disclosure.

About Barclays Corporate

With a clear focus on quality relationships, Barclays Corporate provides integrated banking solutions to businesses with an annual turnover of more than £5 million in the UK and large local companies, financial institutions and multinationals in non-UK markets. We facilitate the success and growth of our clients by providing lending, risk management, cash and liquidity management, trade finance and asset and sales financing. Additionally, our clients benefit from the breadth of the Barclays Group, through access to the investment banking services of Barclays Capital including debt and equity capital markets, the private wealth management expertise of Barclays Wealth, and the card and payment services of Barclaycard. Barclays Corporate employs 11,900 people globally. For more information please visit www.barclayscorporate.com.

About Barclays

Barclays is a major global financial services provider engaged in retail banking, credit cards, corporate and investment banking and wealth management with an extensive international presence in Europe, the Americas, Africa and Asia. With over 300 years of history and expertise in banking, Barclays operates in over 50 countries and employs 147,500 people. Barclays moves, lends, invests and protects money for customers and clients worldwide. For further information about Barclays, please visit our website www.barclays.com.

Appendix 1

From: Sharman Secretariat [mailto:sharman.secretariat@frc.org.uk]

Sent: 31 May 2011 16:36

To: Rusling, Graham : UK Banking Risk

Subject: Sharman Inquiry - request for evidence from Barclays

Dear Mr Rusling,

You may be aware that the FRC recently announced the launch of an Inquiry led by Lord Sharman to identify lessons for companies and auditors addressing going concern and liquidity risks. A Call for Evidence has now been issued and is attached. The Panel felt that they would be especially interested in your views from the perspective of loan work-out teams and would be most grateful for your input.

The Panel would be particularly interested in your observations about:

- the factors that give rise to entities' loans being transferred into work-out or similar special recovery or monitoring teams
- the early warning signals that as a lender you monitor and/or are alert to and that, if present either alone or in conjunction with other factors, would typically cause you to question the sustainability of the loan facilities for the entity and the recovery of the amounts outstanding
- the factors, whether behavioural or otherwise, that in your experience are more likely to lead to a successful turnaround or that are more likely to result in the insolvency of the entity or a major curtailment of its activities
- your views about the transparent and timely reporting of going concern and liquidity risk in financial statements and audit reports where entities are facing financial distress (see questions 1 to 4)
- Your views, to the extent you feel able to comment, about the issues raised in the remaining questions - question 12 seeks views about the FRC's guidance and question 13 is more general in nature. The other questions seek views about the actual practice of companies and auditors in assessing going concern and liquidity risk. If you are unable to respond to these questions from your experience, your views as to your expectations of companies and their auditors in relation to the matters raised would be very helpful.