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Dear Sirs

Sharman Inquiry – Call for Evidence
Going concern and liquidity risks: Lessons for companies and auditors

We appreciate the opportunity to contribute evidence to this important review being undertaken by the Panel of Inquiry led by Lord Sharman. We welcome the initiative of the FRC to set up the Panel to identify, in the light of the credit crisis, lessons for companies and auditors addressing going concern and liquidity risks.

In addition to providing this written evidence, we look forward to contributing views and providing experts from within our firm for hearings by the Panel if requested in due course.

Our specific responses to each of the questions in the Call for Evidence are set out in the accompanying Annex. The questions can be divided between: (i) those that appear to be focused on the current model of going concern assessment and seek evidence on current practices; and (ii) those that appear to link going concern with the wider topic of risk and risk reporting.

This leads us to ask the question – what is the fundamental purpose of the going concern assessment?

Going concern assessment cannot be a universal panacea

In our view, there is a gap between the expectations of users in relation to the going concern statement in company annual reports and reality. Some readers assume that the fact that the company has performed a going concern assessment, and that auditors have reviewed it, is a guarantee of the sustainability of the business. That is not, and can never be, the case. We believe this expectations gap needs urgent attention and it would be useful if a result of the

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Sharman Inquiry was a greater appreciation by investors and other users of accounts of what the going concern assessment can deliver, and its limitations.

There are many recent examples where critical sectors of the economy have hit difficulties with consequences for wider society– most notably the banking industry, but also pension annuity providers, car manufacturers and, most recently, care home providers. This has led to debates of whether the crisis could or should have been anticipated in each case, and what to do to mitigate the risk of such crises being repeated.

If the sustainability of certain business sectors is judged critically important (because of the impact on wider society, the economy or levels of employment should they fail), then there are various tools available to government, regulators and the industries themselves to address the risks. These will vary by sector, but would include regulatory structures, regulatory monitoring regimes, codes of industry practice and corporate governance arrangements.

In our view, any attempt to develop financial reporting and going concern assessment to be the principal mitigation of the risks of businesses in systemically-important sectors failing is not the right solution. (We would maintain that the financial statements of such companies have in fact often provided adequate information on the future obligations deriving from the business model, so, in any event, it is not obvious what additional accounting information is needed). The going concern assessment, which is fundamentally a statement about the appropriateness of an accounting basis, is not an adequate substitute for appropriate regulation of the business models of critically important enterprises.

What is needed is a more joined-up approach by government, regulators and the business community to address the challenges of critically important sectors. We would however agree that enhanced corporate reporting, including relooking at the purpose of the going concern statement, should be part of the solution, but there are many other more important elements.

A broader debate on risk reporting, financing and going concern

Our experience is that the current model of going concern assessment, as it is currently configured, is not 'broken'. As noted in our detailed responses below, we think the basic mechanics of the current going concern assessment by companies and auditors have worked well in the last few years. We also believe the 'three category' approach in the current literature is appropriate and has resulted in helpful disclosure where material uncertainties arise.

While the mechanical aspects of going concern assessment need not in our view change, we believe the Panel of Inquiry could help open up a broader dialogue on the array of information on risks, liquidity and funding with which company management, boards and investors are provided to reposition the going concern assessment within the more joined-up approach that we refer to above.

This is consistent with our belief, noted in our response to the FRC's recent consultation on *'Effective Company Stewardship'*, that the corporate reporting model should be looked at afresh. There is a need for a more coherent picture of strategy, business model, the board's appetite for risk, the key areas of risk, funding, and performance to be presented in annual reports (where narrative, financial and non-financial information are brought together).

One size does not fit all

We have discussed the Call for Evidence widely within our firm and one theme that has come across consistently in discussions with audit and restructuring practitioners is that company circumstances differ depending on the business sector and a variety of other factors.

In our view there is no 'one size fits all' combination of information about risk, capital and financing of the business model that suits all companies. The starting point should be that companies need to understand investors' and users' needs for information on their business model and its viability – this will vary by sector.

There may be useful practices in some sectors, most notably financial services, that can be applied to other parts of the corporate community. The Call for Evidence does not refer specifically to the financial services sector although we gather that in subsequent Panel hearings the experiences in this sector may be explored in more depth.

Encouraging innovation in reporting

We support the inclusion of a fuller going concern statement by companies to assist the readers of annual reports. It should be linked to the sections on funding and risks, setting out the key responsibilities and sensitivities.

Such a statement should provide greater explanation of the assumptions on which the statement is based, together with an indication of risks to which they are subject. A newly positioned going concern assessment should try to provide an answer to the question: "what does the company think the future holds?" The auditors could confirm that the assumptions and risks disclosed, overall, are a reasonable and balanced summary of the assessment that they have examined in the course of their audit and that nothing of significance has been omitted. It would also be possible to envisage a greater focus on judgmental statements about future risks but this would require a different approach by both companies and auditors (potentially including safe harbour provisions for both directors and auditors).

An enhanced model would reposition the going concern statement as not just a statement about an accounting basis but as a clear explanation to readers of the nature of the assumptions and risks that underpin the enterprise's financial sustainability. Equally it should be made clear what it does not mean. Neither companies nor auditors can provide certainty about the future, nor can they predict risks that are as yet not foreseeable. The model would not remove the responsibility of management and board directors to act in the best interests of the company and its shareholders, nor remove the responsibility of investors

to make their own economic decisions, but would provide them with enhanced information with which to do so.

This would be a new departure for financial reporting and one where good practice will emerge through companies and auditors working together in the context of the particular industry and business concerned. Consequently, we think that this is an area where the Panel should promote a culture of innovation in reporting. The financial reporting lab proposed by the FRC could help to develop and pilot new reporting templates.

We would be delighted to discuss this evidence further with you. If you have any questions in the meantime regarding this letter, please contact Pauline Wallace (0207 804 1293), Andrew Ratcliffe (0207 212 4685) or Graham Gilmour (0207 804 2297).

Yours sincerely

PricewaterhouseCoopers LLP

ANNEX 1

Detailed responses to the Questions

Transparency of going concern and liquidity risk

1. What combination of information about:

- **the robustness of a company's capital;**
- **the adequacy of that capital to withstand potential losses 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?

- We note the emphasis in this question and elsewhere in the call for evidence on the 'robustness of a company's capital', however our experience is that for the vast proportion of companies the most important element in relation to going concern is cash. Other than in financial services, companies that fail mostly do so because they run out of cash (or because their committed bank lines are withdrawn because of a covenant issue or other breach), not because they run out of capital or even because they incur trading losses. Capital is important for banks and financial services entities, but for most companies appropriate monitoring of the cash position and maintaining adequate financial headroom are the most important factors.
- However, as noted in our covering letter, we believe there is scope in company annual reports for enhanced discussion of, and greater linkage between risk, the business model and its sustainability, financing and going concern. Disclosures on going concern have historically tended to be separate from those on risk. Presenting these in a more holistic, joined-up way is likely to be of benefit to investors and other stakeholders.
- There is no 'one size fits all' combination of information about risk, capital and financing of the business model that suits all companies. Companies in different business sectors will have different considerations. The starting point should be that companies need to understand investors' and users' needs for information on their business model and its viability – this will vary by sector.
- The FRC should encourage companies to experiment with enhanced reporting. This is an area where the financial reporting lab proposed by the FRC may be able to play a useful part.

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?

- The FSA Listing Rules require price sensitive information to be disclosed on a timely basis and in our experience the FSA enforces this rigorously. This applies not only to profit warnings, but also to other types of financial difficulties.
- The Prospectus Directive requires disclosure of risk factors. These are approached differently from IFRS financial statements and can be driven by legal practice – risk factors tend to be all encompassing and baldly stated with no accompanying mitigating factors. IFRS financial statements drafted for annual reports in the absence of an offering document tend by contrast to include mitigating factors when describing measures that management might take to alleviate going concern risks. Where companies have issued prospectuses (for example in a rescue rights issue), there is a tendency for the disclosures used in prospectuses to flow back through the next annual or interim financial statements.

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?

- Ideally, information on the business model, risks and going concern would be positioned as part of a holistic communication process, such that companies report on a more continuous and consistent basis.
- The reality of the current corporate reporting model and the market environment is that companies report on their financials twice a year (annual and interim reporting). Outside of those cycles, there is a presumption that anything that is said on the subject of risk and going concern is 'bad news' and likely to be viewed negatively by the market.
- Against these market realities and faced with the challenges of the current conventions of reporting frequency, formality and rigour (such disclosures often have to go though legal counsel review), companies may consider that it is difficult to put out messages in the public domain in any other way.
- In addition to these factors, companies are likely to have the normal concerns regarding confidentiality and competitive advantage. In some cases, companies may perceive that full disclosure may become a 'self-fulfilling prophecy' – for example if a company's business model is based on receiving up-front payments from customers before building its product, those customers will be reluctant to commit funds if there is a going concern uncertainty.

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?

- We understand the reference to IFRS arises because the call for evidence is focused principally on listed companies at this stage, rather than any particular concerns about IFRS as compared to other frameworks of accounting. (We are not aware that the replacement of UK GAAP by IFRS for the consolidated financial statements of listed companies from 2005 has had any significant impact on the practical aspects of going concern assessment by companies or auditors.)
- As noted above, while capital is important for banks and financial services entities, for most companies the cash position is a more important consideration. The range of information necessary to enable users to obtain a full understanding of risk, financing and going concern will differ from industry sector to industry sector. This is not something that can be addressed solely through accounting standards – companies need to understand the needs of their stakeholders for information on these matters and provide a range of information accordingly.
- We are currently undertaking a survey of leading UK investors' views on different aspects of corporate reporting. We will provide the Panel with a copy of relevant findings from this survey when it is published in the summer.

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?

- **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 and 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 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?**

- Our experience across the range of companies that we audit or advise is that there is variation on the extent and scope of documentation on going concern, the rigour with which it is performed and the types of risks considered. This variation is a function of the size of the company, the business sector, the experience of management and the ways in which companies are financed. We provide here only a few examples of

trends that we see – we would be pleased to discuss our experiences with the Panel in more detail.

- For most companies, a board or audit committee paper will be prepared by the chief accountant and presented by the financial director, outlining the annual assessment of going concern. (Where companies have financing difficulties, it is more likely that a third party will be assisting the company in producing the necessary documentation, either at the insistence of lenders or because management need the additional expertise.)
- Typically this will be 2-5 pages in length and will include information on the business outlook, cash flow forecasts for at least a year from the date of approving the financial statements (and usually for longer, say 18 months), commentary on funding and net debt, and some form of down-side sensitivity analysis. Cash flow forecasts and budgets will generally build-in the effects of seasonality. Some companies will include projections or budgets for a longer period into the future – say three years.
- The type of sensitivity analysis performed will vary by industry but, for example, a consumer goods business might include the effect of a % reduction in EBITDA, a % reduction in revenue, and a % increase in trade debtors as a % of sales. Some companies will ask the question: "What would sales need to fall by to give us a problem?"
- Some companies will benchmark their working capital position against their peers, using publicly available financial information.
- Companies that are cash-rich and have adequate financial headroom will generally need to spend less time discussing and documenting the assessment of going concern. The formal assessment may for them be a relatively mechanical exercise driven by financial reporting requirements, though they may still need to monitor loan covenants in order not to breach these.
- The amount of time spent by audit committees or risk committees looking at going concern will also vary. Some will spend little time because they do not need to, and will simply approve the board paper prepared in advance. By contrast, where there are financing difficulties or where other going concern uncertainties arise, several hours may be spent by the audit committee.
- The very largest FTSE 100 companies tend to conduct sophisticated enterprise-wide risk management analyses (for example, various risks will be identified and presented in the form of a 'heatmap' that plots likelihood of a risk materialising against scale of impact, and monitored over time). Those boards and audit committees that spend a large proportion of time considering the different areas of risk across the business may not need to spend a great deal of time on going concern because the risks and actions to mitigate those risks are well understood.
- Separate risk committees tend to be less common outside the FTSE 100.
- As noted further below, our experience is that in general the above procedures have improved significantly since the beginning of the financial crisis.

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?

- The procedures and documentation used in connection with working capital reviews tend to differ from those used for financial reporting because the purpose of the exercise is different. The level of assurance required from management when raising capital is greater than when issuing annual financial statements and hence there is inevitably greater due diligence around a capital-raising. Also, if capital is being raised (for example in a rescue rights issue), then the company's headroom may be tight so there will be an increased focus on going concern.
- For these reasons, we believe it appropriate to maintain the current distinction between the work performed (by management and by auditors) for working capital reviews and for the going concern assessment in relation to financial statements.

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?

- As noted in response to Question 5, this varies by company and by business sector. Some companies may have sophisticated processes for tracking cash on a weekly or even daily basis, others less so.
- Our experience is that while most businesses are conscious of the need to manage the cash position, there may be less awareness or understanding in some cases of the impact of banking covenants.
- Where a company is backed by private equity investors, there is typically greater scrutiny of the cash position and of the position with regard to banking covenants on a continuous basis.
- Some enterprises do not issue interim financial statements, but for those that do, our view is that the process undertaken by the company to assess going concern at the interim stage should be the same as for annual financial statements.

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

- The phrase "natural business cycle" is capable of a wide range of interpretation and will be inherently judgmental. Different business sectors have different business cycles. For a fashion business this may be six months. For a pharmaceutical company, the lifetime of patents and the R&D pipeline for new products may be in the range of 10-15 years.
- The directors tend not to use the going concern assessment to drive business planning over the cycle – rather it is driven by a separate strategic planning exercise.
- The larger FTSE100 companies tend to have more sophisticated processes for considering strategy, risk and the sustainability of their business models. They may

have run scenarios to look at what events might endanger the sustainability of their business model (for example, for an energy company, a major environmental disaster).

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?

- The current three-category model used for financial reporting and auditing has in our view worked well over the last few years. It is well understood and has the advantage that, in cases where there are material uncertainties, it drives appropriate disclosure of the company's circumstances in the financial statements.
- Commentators have from time to time suggested that the current 'category 2' spans a range of situations from the less severe (eg a company that simply needs to renew its bank facilities) to more serious cases (eg a company that is on 'life support' but has not yet ceased to be a going concern), and that it might be helpful to bifurcate this category so that there are four categories in all.
- We have considered this but on balance believe the current three-category approach should be retained. If category 2 was split there would then be questions of judgment at the margin as to which category should be used. Indeed, one could have an almost infinite series of gradations, but this would not necessarily result in more meaningful disclosure to the market.
- Our experience is that most boards will come to appropriate judgments about the circumstances of their companies. Where material uncertainties do exist, and while it is always difficult to generalise, our experience in the last few years has been that directors, mindful of their fiduciary duties, have been more willing to 'do the right thing' and have not resisted including additional disclosures. There is a view that the market will punish more severely those companies that do not acknowledge the existence of financing or liquidity issues and then present the market with an unwelcome surprise, than those companies that are more willing to communicate the uncertainties at an earlier stage.

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?

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[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:

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.

- The financial crisis and associated market and economic uncertainty over the last few years have heightened the focus on going concern issues. The basic mechanics of the going concern assessment have not changed, but the financial crisis has led to different risks being considered, sometimes for the first time. The tougher lending conditions applied by some traditional providers of finance have meant that some companies have also had to seek out new sources of funds.
- Counterparty risk has become critical for some companies – and companies have started to give more consideration to the question: "What other stakeholders could cause us a problem?" (For example, the risk that a key supplier or customer may itself fail). In the banking crisis of late 2008, some cash-rich companies were concerned about the counterparty risk that their banks might fail.
- Changes in attitudes in the credit insurance industry have become a factor for some businesses – suppliers might increasingly demand cash up-front from a customer because the supplier's credit insurer may no longer be prepared to underwrite the risk of that relationship.
- As noted above, companies are becoming more sophisticated in their analysis of risks and are widening the range of risks being considered.

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?

- Our audit approach on going concern is driven by the requirements and guidance in audit standards (International Standards on Auditing – UK & Ireland). In addition, during the financial crisis, we provided additional 'awareness' training and guidance to audit staff on the issues around going concern.
- Beyond the content of the specific audit standard on Going Concern, a key element for the auditor is obtaining a good understanding of the business and its people. This enables the auditor to answer questions such as: How good is management at looking into the future? How well attuned are senior managers' risk antennae? How good is the company's relationship with its bankers and other providers of capital?
- We believe that, as with the basic mechanics of the going concern assessment by companies, the audit approach has worked well in recent years. The bigger question is whether, as noted in our covering letter, the going concern focus and the disclosure given by companies and auditors is at present too narrow. We would like to see a dialogue around a broader, more future-oriented model for both company disclosure of risks and the related assurance by auditors.
- The most significant industry sector where different processes may apply is banks and other financial institutions. The key considerations in relation to going concern in a banking environment were set out in our written evidence to the Treasury Select Committee inquiry on the Banking Crisis (see extract from our evidence in Annex 2).

- During the financial crisis we provided our audit teams working on banks and other financial institutions with additional guidance relevant to the circumstances of those engagements.
- Generally the processes used in audit engagements when there is overseas reporting in addition to UK reporting are the same. As a network, our global audit methodology used throughout the world is based on International Standards on Auditing.) There is a difference insofar as ISAs (UK & Ireland) require the going concern period to be 12 months from the date of signing the accounts, rather than 12 months from the balance sheet date, but this has not caused difficulties in practice.

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?**

- Our experience was that the Guidance for Directors issued in 2008/09 was very helpful in clarifying responsibilities at the time of the financial crisis, and well received not only in the UK but also in other countries.
- As noted in our response to Question 9, we believe the current 'three-category' model is appropriate, well understood, and has worked well in the last few years.

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

- We understand the FRC is interested in the behavioural factors around going concern – there is a view that company management have a naturally optimistic outlook and may go through a process of 'denial' when financial difficulties first appear on the horizon.
- While those reactions might have been true some years ago, and it is always difficult to generalise, our experience in the financial crisis of the last few years has been that management and boards have generally been more willing, where significant uncertainties arise, to provide the necessary additional disclosures in financial statements. There has been a greater acceptance of the need not to be perceived to have misled the market. Similarly, management and boards have generally not resisted the inclusion of going concern emphases of matter in audit reports where we have considered these appropriate.

ANNEX 2

Treasury Select Committee inquiry on the Banking Crisis (Session 2008-09)
Appendix 1 to PwC written evidence on Banking Crisis (January 2009)

GOING CONCERN IN A BANKING ENVIRONMENT

For most non-banking companies a going concern analysis consists of three basic steps:

— prepare a cash flow forecast covering at least the next 12 months from the date that the accounts are signed (in practice many forecasts go out for 18 months);
— collect together the committed banking facilities that a company has obtained; and
— ensure that, cumulatively, any cash deficits are accommodated within the committed banking facilities.

There are situations where the committed banking facilities may expire during the period being reviewed. Where this is the case, management and auditors need to consider the probability that these facilities will be renewed or that new facilities can be found.

For banks, the above approach does not work. Banks globally all operate on the basis that the assets on their balance sheet have longer maturities on average than their liabilities (the so called "borrow short lend long" strategy). Also, whilst banks will establish credit lines with other banks, these are rarely in the form of a committed facility. Therefore any traditional form of going concern analysis would conclude that banks are structurally insolvent.

However, banking has always operated on the basis of confidence. Provided that there is confidence in a particular bank, retail depositors will not withdraw their funds (even though contractually many could do so on demand) and the bank will be able to refinance its wholesale borrowings as and when they fall due. Historically, management and auditors have signed off on the going concern assumption in banks on the grounds that there is no evidence that there is any lack of confidence in the bank and such a deterioration in confidence would be a remote event. Clearly in the current markets this has become more difficult and more explicit reliance on government support is sometimes needed in order to reach such a conclusion.

It is also true that, in an industry built on confidence, both management and auditors need to be aware that the mere inclusion in a set of accounts of a warning that there might be any uncertainty over going concern could result of itself in a loss of confidence making failure self fulfilling. For this reason, before including any such uncertainty in a set of accounts, both management and the auditors are under a duty to first report this to the FSA. It is then the responsibility of the regulator to determine the proper course of action which, depending upon the bank in question, may range from providing central bank support so as to remove the doubt to effecting an orderly wind down or takeover of the bank.

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