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Our ref jg-j/gf

30 June 2011

Dear Mr Grabowski

Sharman Inquiry Call for Evidence

On behalf of KPMG in the UK, I write in response to the Call for Evidence by the Sharman Secretariat dated 11 May 2011.

We welcome the Panel's work. Having been through the worst financial crisis for many decades, it is only right that lessons are learnt from the experience, both in terms of spreading best practice where things went well and recognising opportunities to do better. If the review is to be of benefit we are convinced that the focus needs to be on the first four questions – ie improving the information provided to investors. It would be all too easy to concentrate on procedural aspects (covered in the subsequent questions). We believe this would be a mistake as in our experience the processes adopted by both directors and auditors in arriving at their going concern judgements in general work well.

Current requirements aim in the first instance at deciding whether the company no longer has a realistic alternative to an insolvency procedure, because, in such a case, the basis of accounting must be changed to the fundamentally different break-up basis. Preparation of financial statements on a going concern basis is therefore by no means a "guarantee" that a company will continue as a going concern even for 12 months. On the contrary it is a merely a statement that there are realistic alternatives to failure and we are concerned that this is not fully appreciated by users. We could try to address this "expectation gap" by raising the bar for the going concern basis, for example to require the same level of confidence as for a working capital statement. However for the reasons we articulate in the Appendix we do not think this would be helpful.

Assuming that a company is judged to be a going concern, consideration needs to be given as to disclosures regarding the assumptions underlying that conclusion (which may also be highlighted in the auditor's report – an "emphasis of matter"). Within that context, we believe the improved Financial Reporting Council (FRC) guidance has generally worked well, but more could be done on wider risk disclosure of a company's business and capital/financing model.

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The challenge with this is where to draw the boundary: at one extreme, companies could be required to publish internal forecasts and budgets, but there is unlikely to be any enthusiasm for this. In addition even these internal projections may not adequately articulate how comparatively low-probability, high-impact events might affect the company. The current Eurozone debt crisis is a case in point, where possible dislocations in the inter-bank market might have wider repercussions not just in the financial sector, which are very difficult for individual corporates to assess. A similar concern is what longer term trends might merit consideration – for example a return to a comparatively high interest/ high inflation rate environment? These difficulties do not in our view mean that it should not be attempted. We must however be realistic as to its ability to prevent corporate collapse and such reporting does require some "safe harbour" provision for both directors and auditors.

Finally, we believe that banks are somewhat different. For banks, confidence is at the heart of a bank being a going concern, and "going concern type" disclosure in accounts does not really work for such entities except in so far as it indicates there are no concerns; in other circumstances it can too easily become a self fulfilling cause of collapse. As a consequence potential issues need to be identified at an earlier stage and disclosures need to be framed with this objective in mind. This would in our view indicate more disclosure around appropriate stress tests and specific topical risks, as for example recommended in the recent Financial Stability Report in relation to sovereign and banking sector exposures. An improved dialogue between regulator and auditor, as envisaged by the draft FSA Code of Practice, can contribute to this process.

As regards the auditor's role more generally, the responses to the EC Green Paper "Audit Policy: Lessons from the Crisis" were consistent in the view that reporting on the financial health is not the purpose of an audit (which, rather, is currently designed to express an opinion on the truth and fairness of financial statements within a specified accounting framework rather than for any other purpose).

Notwithstanding this, investor sentiment (as summarised by the EC) was that, "auditors should also provide comfort regarding the financial health of companies, but only within their current remit and without any extension of the auditors' role." This may be ambitious, or even unrealistic (and carrying inherent tensions, ie providing comfort without extending the role), but there are a number of measures – some of which are already being contemplated by different regulatory authorities – which might improve the *status quo* without radical change.

Examples of these, which we would support and for which an auditor's review may be appropriate, include requirements to:

- improve disclosure by companies of the business model and the longer-term risks involved;
- disclose the extent of changes in key assumptions and stresses that might threaten short-term liquidity and financial viability of the company;

- explain the process by which the directors have satisfied themselves as to the appropriateness of the use of the going concern basis; and
- move the going concern disclosures to a new report on how the audit committee dealt with significant judgments etc.

Further work might also be undertaken to consider the merits and cost/benefits of further measures such as the *Procedure d'Alerte* in France to understand whether this has, at a proportionate cost, provided earlier warning of companies that might fail and/ or allowed for appropriate remedial action.

* * *

Our responses to the detailed questions are set out in the Appendix to this letter, where they are preceded by an overall assessment of the *status quo* and the possible ways forward. We trust that the Panel finds these comments helpful to its deliberations. Please do not hesitate to contact me should you wish to discuss further any aspects of our response.

Yours sincerely

John Griffith-Jones
Chairman

Appendix

Part 1 – Assessment of the *status quo* and possible ways forward

Where are we now?

1. Before reviewing recent experience, it is worthwhile being clear about the current role of going concern in accounting. Accounts (and audit report) disclosure does not aim, as an end in itself, at predicting the company's future health, eg as to whether it could soon be in need of "rescue". Rather, it has the aim of deciding whether the company no longer has a realistic alternative to an insolvency procedure, because, in such a case, the basis of accounting must be changed to the fundamentally different break-up basis. Disclosures in accounts (and emphasis-of-matter by auditors) aim only at informing shareholders – albeit in a graduated way, with more disclosure the more uncertain the case is – about the directors' decision, with reasons, that there is a realistic scenario in which the company survives. This is the case even if the directors judge that the realistic scenario is one in which the company will be "rescued". This may not be well, or widely, understood. For example, although referenced to the Financial Reporting Council (FRC) guidance, which is itself clear on the point, the Listing Rules and UK Corporate Governance Code use language ("is a going concern") that might contribute to misunderstanding[1].

2. As we see it, the question is not whether this accounting process itself should change; no-one would, we think, suggest that a company's accounts should change to a break-up basis and then change back again once it is rescued, if indeed rescue was foreseen as a realistic possibility. Rather, the question is whether some additional reporting with a different aim is also appropriate.

3. Before turning to that, how effective has accounts disclosure been within the context of its aim during the recent global crisis? We believe that the system, as enhanced by the FRC on a very timely basis in late 2008, generally worked well. Good disclosure of the short-term (foreseeable future) risks was made in appropriate cases, at least in qualitative terms though perhaps not in quantitative terms. There was increasing, but by no means universal acceptance that companies' disclosures, and even auditors' emphases-of-matter, should be read and considered rather than treated as a cause for "knee jerk" reaction. As auditors we certainly found, however, that the latter remains a view among some clients and occasionally a cause of initial resistance to appropriate reporting (including to the words "material uncertainty/ significant doubt" in directors' reporting). We also found a few cases where the directors' process, for assessing the going concern basis of accounting, only achieved an appropriate degree of rigour after challenge from the auditor.

4. The part of the economy to which the system is less well suited is the banks. Their role is, of course, to create liquidity for the rest of the economy and so they are themselves necessarily structurally illiquid. They depend on confidence, which can evaporate quickly. Making

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1 LR 9.8.6R(3); Code Provision C.1.3.

disclosure when the next periodic accounts are presented, and assessing confidence over the following 12 months or so, is unsatisfactory. In particular, such disclosure could contribute to or crystallise a crisis of confidence. Rather, it is sufficiently important in these cases that potential going concern issues need to be caught at an early stage by the regulatory process.

5. Reverting to the generality of cases, the Panel is rightly interested not just in periodic accounts but in other reporting occasions. We have two observations on current practice here. First, we think that business reviews accompanying accounts are, on the whole, probably not as good as they could be. In particular, the longer term, key drivers of performance and challenges to the business and capital/ financing model too often do not shine though. Second, reporting in response to developments, eg under the Disclosure and Transparency Rules (the DTR, rule 2.2.1 being the former Listing Rules' continuing obligations) is not often seen in respect of going concern issues, at least not until a late stage. This observation is, however, anecdotal rather than empirically based. We recommend that some study might be done into this.

Where might we go?

Accounts basis and wider reporting

6. The first thing that we have considered is whether the look-forward period for going concern assessment for accounts purposes should change: ie, from at least 12 months (from signing of the accounts), to the business cycle. We have concluded that this would be very difficult to do in support of an accounting treatment (although business model reporting could be done, as explained below). It could require a look-forward of five years or more and it would be very difficult to conclude that, in the event of threats emerging later in that period to the company's continuing in business, there were no realistic scenarios that would permit that to happen As such we would question whether extending the period would ever change the answer or if it would just increase unrealistic expectations. Moreover, so far as the context of accounting is concerned, we are not aware that the current system, of at least 12 months, has produced any systemic failure to use the break-up basis when required.

7. Whilst the look-forward period ought to remain as it is, disclosure of the assessment, although generally good, might be improved. First, we think that there may be merit in including, in appropriate cases, quantification of what movement in key risks – eg, what drop in sales, what level of interest rates, etc – would cause the company no longer to be a going concern. This would give shareholders a better sense, or measure, of how much risk there is. We acknowledge, of course, that some risks are difficult to quantify, particularly those that are comparatively low probability but high impact. For example, it may be difficult for a retailer to quantify the effect of loss of credit insurance to its suppliers, or for a corporate generally to assess the effect on the corporate credit supply of a Eurozone debt crisis; these remain qualitative matters. It would also be necessary to decide which cases are appropriate for this disclosure, and how one would frame a requirement. However, the matter seems worth looking into.

8. Second, directors might be asked to disclose not only what are the risks for the next twelve months or so and why there is a realistic alternative, but what process the directors went through to assess these matters. For example, what particular period did the directors consider through detailed forecasts: was it a bare 12 months or, if something more, what more?

9. Next, we support the idea of wider reporting on how audit committees discharge their duties. In cases where the going concern assessment is or could be key – perhaps both the FRC guidance's "example 2" and "example 3" cases – it ought to feature in a report on the audit committee's activities, along with the several other significant judgments made by the board in preparing the accounts. Further, and subject to questions of, eg, cost/ benefit, we support audit reporting on that report. We could envisage a report on the completeness of the particular list of issues and on the content of the particular disclosures (on a qualified/ unqualified basis). At the same time, it should be questioned whether the concept of an emphasis-of-matter, as it stands today – occasionally singling something out on an exceptional basis – would be redundant. The wider reporting would replace it.

Business and capital/financing model reporting

10. Whilst the foregoing is in the context of the accounts objective, that does not mean that there cannot be some other disclosure that aims at giving more information about the business and associated capital/ financing model and the long term. After all, whilst it is very difficult to say what might be expected to occur in the longer term, it is there that the strategic challenges to the business first arise (eg, before, if that is how events turn out, they crystallise as short-tem liquidity concerns) and can be pointed out. So whilst, for example, a return to late 1990s interest rate levels is remote in the short-term, it would be appropriate to identify that as a longer term dependency if such rates would pose a serious challenge to the business model. (That particular long-term issue could apply to many companies. We wonder whether some are beginning, mistakenly, to think of low rates as the norm.)

11. In addition all capital/financing models aim to strike a balance between maximising returns to shareholders (which tends to lead to financial and/or operational gearing) and minimising the risk of failure. The extent of this gearing and its ability to stand sudden shocks is another area which merits improved disclosure. It is in this area that stress testing plays an important role, particularly in considering comparatively low probability events which nonetheless may have high impact.

12. We think that the directors' report business review is the right place for such disclosure objectives and that it might be improved by three measures. First of all, it could be upgraded to cover the business model and associated capital/ financing model more explicitly. For example, the Company Law Review (2001) recommended disclosure of the principal drivers of performance; and the abandoned statutory Operating and Financial Review (OFR) requirement (2005) was clear that the purpose of the OFR was, "to assess the strategies adopted by the company and the potential for those strategies to succeed." Better business model reporting could provide shareholders with information about both the longer term risks and short term

shocks that the company's strategy entails, and the company's approach to managing them. Second, external audit could have a role here in reporting on that business review, going further than the current consistency reporting. This would be subject to questions of, for example, cost/ benefit. Third, the question of enforcement by the Financial Reporting Review Panel (FRRP) could be examined. Finally under this heading, the messages in the FRC's "Cutting Clutter" initiative should not be overlooked. Long factual lists of risks do not convey a message. Focus on key risks, and commentary upon them, is what counts as effective communication.

13. Overall, we have a set of requirements that, subject to some upgrading, could produce valuable transparency if better complied with; auditors and the FRRP could have roles to play around compliance. In view of the inherently subjective nature of such forward looking statements it must be recognised that both directors and auditors would require some degree of safe harbour.

Continuous monitoring and reporting on going concern?

14. Continuing with the theme of enforcement, and moving beyond periodic reporting, evidence might be sought as to the quality and timeliness of compliance with the DTR 2.2.1 obligation. Does the requirement need to be changed or supplemented, or merely better enforced?

15. Thinking outside of the periodic reporting cycle again, there is a question about directors' day-to-day management of the company: should there be some system for overseeing that and reporting when going concern issues arise? An example is the French *Procedure d'Alerte* system. This is probably the most challenging policy area: who would be overseen (just listed?); who would do the overseeing; to whom would they report; at what stage would an issue merit reporting; and with what object – merely to inform or actually to take preventive action before the company begins a trajectory that *might* result in it going under?

16. One possibility is that external auditors do the overseeing. However, it is difficult for an outsider to keep a continual watching brief. It would probably be necessary to require that auditors be supplied with board papers and minutes after every board meeting. (Such a role for the auditor may duplicate some of the non-executive director's responsibilities. Would that be appropriate?) The question then shifts to, for example, after how many months' reporting of, say, flagging sales, is some further enquiry required on the part of the auditor or even some reporting (to the FRC perhaps, as companies should already be reporting to shareholders under the DTR)? It could also damage the extent of openness on the part of the directors that an auditor needs to do his main job efficiently (or, in the extreme, at all). That said, the French procedure, although set in a different environment (and one more open to intervention in the market), could be examined to see how it has been made operational, and at what cost, and how effective it has been.

Banks in particular

17. Banks are, however, a case where the cost/ benefit case for an early warning system is much clearer. It is not only shareholders' investment that is at stake if a bank fails, but public depositors and indeed potentially the financial infrastructure essential for the entire economy. So some monitoring of the directors' management of the business seems unavoidable. Indeed this has long been the role of the prudential regulatory architecture. Whilst the Financial Services Authority (FSA) has the leading role, and ultimate responsibility, it has been widely recognised that a return to a more regular regulatory dialogue, between auditors and the FSA and directors and the FSA, is one key element of this, although regulatory tools such as stress testing remain fundamental. Accordingly, we support the FSA's recent draft Code of Practice. It is a very positive development in promoting an effective and open relationship between auditors and supervisors. This increased coordination will enhance the FSA's ability to highlight emerging problems and, we trust, also enhance the information available to the auditor.

Part 2 – Specific questions asked in the *Call for evidence*

Question 1: Annual and interim corporate reports disclosure

18. With its references to the robustness of capital and the ability of capital to absorb losses, we presume that this question is focussing primarily on the financial services (eg banking) sector. A bank's capital is the measure of its ability to withstand losses whilst leaving the bank operational, including that those who provide funding to it (whether retail or wholesale) remain confident and maintain their funding. So if a bank has the required level of capital, as set by the prudential regulator, then, in that sense, it is robust. By implication, therefore, disclosing that the bank has surplus capital is to disclose that the regulator considers the bank to be robust. A different sense of "robust" might be to ask whether a bank's surplus over the required level is robust. If so, one is really asking whether the prudential regulator has set a high enough level of capital in the first place. If that is the problem, then accounts disclosure is not the solution.

19. In any event, bank capital is already disclosed under IAS 1 paragraphs 134 to 136. These disclosures, or their significance, may be difficult to understand without sector expertise. In Part 1 we suggest that quantified disclosure might be made of changes in conditions that would cause failure (eg, losses on Eurozone sovereign debt that could not be withstood). This may be more instantly understandable and readers may in part form their own judgement about the likelihood of the changes in key variables actually occurring, although lack of sector expertise may make that more difficult or, at the extreme, subject to misinterpretation. The same quantified approach would also improve disclosure in the corporate sector – primarily the ability to withstand adverse trading conditions (but also reliance on par ticular funding or capital structures).

20. Banks, however, cannot be addressed only by public disclosure. For a bank that is at risk more than others, the current disclosure requirement, and the quantification alternative above, could lead to a collapse in confidence. The FSA has made it clear to us on several occasions that issuing a set of bank accounts with an emphasis-of-matter paragraph in relation to going concern is not an option (except in very rare circumstances where the market has already taken account of the issues). In its view the very existence of such a paragraph means the FSA would be forced to intervene to "resolve" the situation.

21. What is needed instead is some earlier analysis and action. The longer term risks of a bank's business model need to be looked to, capital and funding requirements set accordingly or, even, the model changed to eliminate dependencies/ concentrations of risk. We refer in Part 1 to the changes already under way.

Question 2: Disclosures outside annual and interim corporate reports

22. The DTR requires a listed company to report certain price sensitive information (primarily within DTR 2.2.1). Whilst we are not aware of any systematic study, we believe there may be a tendency to report "facts" rather than possible future implications for the company of the current situation. (In Part 1 we suggest that some further study could be undertaken in this area.) If the annual and interim reports more clearly articulated future risks to the company's business/financing model then it could encourage more explicit updating of such information.

Question 3: Barriers to disclosure

23. We believe the main barrier to the provision of information outside of the annual and interim reporting process is the lack of any explicit requirement to disclose this type of information. As noted above, the existing requirements for listed companies might not be resulting in timely and relevant disclosure.

24. As noted in Part 1, we believe that there is a lack of understanding of the basis on which going concern is assessed for accounts preparation, and the auditor's role. This is a barrier to additional reporting. Companies may be understandably reluctant to making public comments if they believe they will be perceived negatively and/ or become self-fulfilling. Similar consideration applies, we suppose, to DTR 2.2.1 reporting. Removing these barriers is a matter of "education" of the marketplace; the FRC could play a role here.

Question 4: International Financial Reporting Standards (IFRS)

25. Outside of the financial sector, capital (and the IAS 1 capital disclosure) is tied less closely to the question of going concern, although its sufficiency will affect the views of other providers of finance. Going concern in the short term is really a question of liquidity. This is covered by the IFRS 7 (eg, future cash payments on financial liabilities, which, incidentally, are not disclosed under "old" UK GAAP) and going concern disclosures. Accounting measures are not of primary relevance to a reader's understanding of going concern, but are mainly limited to: the

historical cash flow record, which is cash rather than an accounting measure; the profit and loss account, but only in so far as it indicates overall current viability (profitability); and the balance sheet which is a snap-shot of what is owed, where as in fact timing of those amounts is the real issue. There are only comparatively few occasions when accounting measures are relevant, i.e. covenant tests. (We discount the Insolvency Act's s123(2) test, as not being necessarily accounts-based and rarely being the basis of a successful petition.)

26. In the banking sector the issue is confidence which in turn revolves round capital, even though what underlies this is their need for liquidity. This is because the special position of banks in the economy is maturity transformation. On a normal measure they are *prima facie* insolvent. This necessitates a different approach to running the business, i.e. the regulatory capital requirements that, in effect, assess whether there is enough confidence in the bank to allow it to continue in business whilst structurally illiquid. Whilst an IFRS balance sheet is the starting point for regulatory capital measurements, the definition of capital is set by the regulator and not the accounting standard setter.

27. Banks, do, of course, need some liquidity lines of their own, but the two key points about going concern are usually: how much capital is required; and how much does the company have? The second question is one of a specialised prudential measure, capable of taking into account, for example, the softness of valuations. Its computation is regulated by the FSA. The first question is a simple threshold level decided by the FSA. It is up to the FSA to set it high enough.

28. Accordingly, going concern considerations do not *per se* require amendments to the current recognition and measurement requirements of IFRS. We note that something akin to the current proposals, to move from an incurred loss model (which has long been the UK GAAP basis too) to an expected loss model would be a positive accounting development in its own right. In contrast, the objective of increasing confidence in a bank's ability to withstand *future* credit losses (still the main cause of stress in a bank's business) needs to be covered by prudential stress testing; we refer earlier on to accounts disclosure in this regard.

Question 5: Directors' processes

29. The approaches taken by companies vary, driven by their businesses and their circumstances. For example, many retailers have weekly cash flow forecasts which are then used as the basis for going concern assessments. In the financial services sector the focus is on regulatory capital. The forecasts used to assess whether the company is a going concern are those prepared to meet the regulator's requirements.

30. In many cases the audit committee is actively involved in the going concern assessment, for example through the review of papers prepared by the executive directors. In those comparatively few cases where we, as auditors, have been faced with the most difficulties, a common theme has been the lack of challenge to executive directors from the audit committee.

31. Cash flow forecasts, based on existing business plans and assumptions, are prepared for the going concern assessment. In many cases this model can be stress-tested by adjusting inputs such as sales growth or interest rates. However, we also find that some companies do not initially consider the potential risks facing them in enough detail or stress their assumptions enough. In such circumstances these are upgraded in response to audit challenge.

32. The main risks included within the going concern assessment are operational risks, such as turnover or customer credit risks, in addition to individually large cash flows. In more sophisticated models, such as those used in the financial services sector, liquidity and credit risks are also included. Finance risks – usually whether the company can finance its operations – are, of course, also present. However, that is less about detailed modelling than about interpretation of the results of modelling and ascertaining, eg, the bankers' views. Some external financial risks are, however, difficult to take into account, such as the possible second-order effect for a corporate of a Eurozone sovereign debt crisis on the banking sector's ability to continue to make credit available.

33. In our experience there is now increased corporate focus on monitoring cash flows and covenant compliance far more closely than before the financial crisis, eg reporting cash flows and covenant compliance to the audit committee/ board on a more regular basis.

34. It is difficult to make recommendations that apply to all companies. The level of work undertaken by directors depends on the level of risk faced in the particular circumstances. We believe this is an area where good governance counts: it is achieved by. responding appropriately to the particular circumstances and risks; it is not achieved by following prescriptive rules.

Question 6: Raising capital vs annual going concern accounting assessment

35. When raising capital, the directors make a statement that, in their opinion, the company has sufficient working capital to meet its liabilities as they fall due over the next 12 months. This test is a high hurdle. For example, ESMA's guidance states that an issuer "should ensure that there is very little risk that the basis of such a statement is subsequently called into question."[2]

36. In the annual accounts process, directors prepare the accounts on a going concern basis even if they do not currently have sufficient working capital to meet liabilities, provided they believe that there is a realistic alternative to liquidation and that they make appropriate disclosures about the risks involved. That is to say, it is a much lower level of certainty, viz that

[2] European Securities and Markets Authority, ESMA update of the CESR recommendations, paragraph 124.

although there are disclosed uncertainties, survival is a realistic possibility. This applies under both UK GAAP[3] (going back to SSAP 2 in 1972) and IFRS.

37. A common scenario is a company with banking facilities expiring in less than 12 months (eg, FRC guidance, appendix II, example 2). Additional disclosure of the uncertainties involved is required in the basis of preparation of the accounts, which is a graduated approach. However, in this situation a company preparing a working capital statement would not be able to make a positive statement – it would be on the wrong side of the hurdle.

38. Whilst the nature of the procedures undertaken when raising capital and for annual reporting is similar, the level of detail required is likely to be significantly different. The increased level of certainty required in a capital raising process will require a greater level of analysis and testing. In addition, the level of documentation may differ since a reporting accountant prepares a narrative report to a sponsor, which given the degree of certainty required and by its very nature will probably contain more detailed information than is required for audit work and audit file documentation.

39. We believe that the level of work required for a working capital statement would be appropriate only if the test required in the annual accounts process were that there was (or that there was not) sufficient working capital to meet the company's liabilities as they fall due over the next 12 months. This would lead to more companies preparing their accounts on a break-up basis (eg, bank facilities falling due within the year). We do not believe that this would provide helpful information – quite the reverse. Nor do we believe that such a test would be an appropriate boundary between the FRC's "example 2" and "example 3" (emphasis-of-matter) cases. Many companies would unreasonably be categorised as "example 3".

Question 7: Regular company reviews of future cash flows and liquidity

40. This varies based on the business and the level of risk. For example, one would not expect a company generating significant cash inflows, operating in a low risk sector and with low gearing to prepare formal forecasts continually throughout the year.

41. Some companies prepare cash flow information throughout the year, for example on a quarterly basis. It is generally a less formalised process than that adopted for the annual and half-yearly assessment although in many cases formal cash flow information is compiled for covenant testing purposes.

42. In the financial sector, the formal oversight of the prudential regulator requires capital and liquidity data to be compiled at more regular intervals using the same process as for the annual and half-yearly assessment of going concern.

[3] FRS 18 paragraph 21: 'an entity should prepare its financial statements on a going concern basis, unless (a) the entity is being liquidated or has ceased trading, or (b) the directors either intend to liquidate the entity or to cease trading, or have *no realistic alternative* but to do so'.

43. Reverting to the corporate sector, those at significant risk usually (but not invariably) do significantly more, updating estimates and testing key measures with greater frequency. Sometimes this step-up in process occurs only after the company has been through its first experience of a rigorous annual accounts assessment.

Question 8: Directors' assessment over natural business cycle

44. Directors often produce business plans that cover a longer period than that required for the going concern assessment (eg, three or five year business plans). However, these are not usually intended to match the business cycle. For example a property company may expect a typical business cycle to be approximately (for example) 10 years, yet prepare a three year business plan. The frequency of updates varies based on the risks faced. Some update plans quarterly, annually or whenever a significant transaction occurs.

Question 9: The current three category model

45. Our comments below are based on the existing model, whereas we take a "fresh look" in Part 1.

46. The FRC's three category model is helpful. We do not believe that additional or fewer examples would be helpful; it is difficult to see what combination of facts exists that is not covered by the current examples.

47. The examples have helped auditors to emphasise to directors what is required from them as part of the audit – in effect that the directors are required to complete adequate procedures to satisfy themselves as to whether the company is a going concern or not before the auditor concludes. On this basis we do not believe additional guidance is required in relation to the current model.

Question 10: Issues resulting in heightened focus

48. The 2008 global financial crisis was, naturally, the cause of heightened focus on the assessment of going concern. However, this was after the crisis broke. Prior to that no-one would have considered it reasonable to plan for a credit crunch or to plan for property values to fall as much as they did as rapidly as they did (the IPD all property index fell 44% in 2 years compared with only 27% in nearly 4 years after the 1990s crash). No-one did plan. Even after the crisis broke, some aspects of it took companies by surprise. For example, some retailers did not even know that their suppliers were extending them trade credit on the strength of credit insurance; when it was withdrawn, they were taken by surprise.

49. The question is: going forward, how does one spot the next "unthinkable" (or unknowable) risk? There can be no complete solution to that. The best that can be done is to put in place better business and capital/ financing model reporting. As noted earlier, that kind of reporting

can look out further than the short-term accounts-basis assessment and also take account of possible stress situations.

Question 11: Auditors' assessment of going concern and liquidity risk

50. The auditor's work is governed by ISA (UK & Ireland) 570 *Going Concern*. Within that standard, the level of work is dependent on the risk faced by the company. This is a matter of audit judgement. As might be expected, where a company has limited banking facilities and operates in a high-risk market the level of work would be far greater than for a company with large amounts of headroom and a stable market for its products. Where a company is profitable and cash generative in a low risk sector but faces large interest payments, the majority of the work would be focussed on the relationship of the company and its lenders and the latter's attitude. Where a company is subject to challenging covenant requirements the focus may be on the profit and cash flow forecasts of the company and whether suitable stress-test scenarios have been applied. Our 2009/10 Audit Inspection Unit (AIU) report, which focussed on areas of significant risk including going concern assessment, stated that they were "generally satisfied with the justification of significant audit judgements and the sufficiency of the audit evidence obtained," and raised no issues on going concern.

51. Audit work includes understanding the process followed by the directors in preparing their forecasts. This will generally involve enquiry and challenge, eg of inputs. This can include, for example, comparing key assumptions to current year actual results, comparison with known information about peers, review of supporting documentation or processes and stress-testing the base case forecast for reasonably possible variations in key assumptions. When going concern is a key risk, this will generally involve discussions with senior management. We may also discuss the company's financial position with external parties, for example their lender, where such a discussion could provide additional audit evidence (although lenders are often understandably reluctant to provide much comfort before their credit committee stage). We do not believe there are significant differences in the procedures used where there is overseas reporting.

52. Discussion of the directors' assessment of going concern would, as appropriate, form part of reporting to Audit Committees. Clearly this would be more extensive when the risks are greater.

53. Some industry sectors merit different procedures. For example, the financial services sector is subject to prudential regulation by the FSA. Discussions between the auditor and regulator may be held (in addition to, not in replacement of, the procedures outlined above). These discussions can be problematic where an institution's ability to continue in business, for at least the next year, is critically dependent upon the FSA's allowing it to do so. This creates something of a "feedback loop". The FSA is highly likely to withdraw an institution's licence if the accounts disclose a material uncertainty that casts significant doubt (and the auditor gives an emphasis-of-matter); yet one pre-requisite for there to be no such disclosure (and no emphasis-of-matter) in such a case, is for the FSA to give sufficient certainty to all concerned that the

FSA will not withdraw the licence. This tends to bring matters to a head: in the knowledge of the stressed-tested outcomes that might occur over the next year or so, will the FSA act to withdraw the licences now; or will it commit to support the institution through the stressed scenarios should they occur? The FSA is understandably reluctant to be forced into making the decision between those alternatives when there is still the realistic possibility that confidence will continue (even though there is significant doubt about that). However, if it does not do so, then it forces the directors (and/ or auditor) into the position of having to make the disclosures (and emphasis-of-matter), effectively causing a crisis of confidence for the institution. Regulatory dialogue at this stage is just too late. Earlier and better regulatory dialogue is needed and changes are underway as noted in Part 1 and should give more time for the FSA to address the issues; we trust that this will also be a two-way dialogue.

Question 12: Amendments to the FRC guidance

54. Our comments below are based on the existing model, whereas we take a "fresh look" in Part 1.

55. Major amendments to the Guidance are not required. The general principle – that the directors should tailor the examples by taking into account the specific facts and circumstances they face – is the correct one. We do not believe that a clearer boundary between the three types of company is required.

56. Whilst in the majority of cases the Guidance has been helpful to auditors, directors and audit committees, we have encountered resistance from a small number of companies to the disclosure in an "example three" scenario, both in terms of the level of disclosure required from the directors in the basis of preparation and the existence of the additional emphasis-of-matter paragraph in the audit opinion. ISA 570 requires the auditor to state that there is a "material uncertainty that may cast significant doubt" on the going concern in an emphasis-of-matter paragraph or qualify if the directors do not use the same words. Although helpful to auditors, paragraph 66 of the Guidance could be more explicit that directors should use the same phrase. The current situation is unsatisfactory. In addition, it would be helpful to a reader of the accounts if the directors' statements as to material uncertainty/ significant doubt were equally or more prominent than the auditor's emphasis-of-matter. It is the directors' role to report this, and it is that that should get the initial attention from readers. Its prominence could be promoted to the face of the balance sheet, for example.