Response from Professor Stella Fearnley to the Sharman Inquiry relating to going concern and liquidity risk.

I do not propose to respond in detail to the questions from the Inquiry but I make the following comments about going concern:

- The problems of going concern have arisen specifically in the financial sector and therefore it may not be appropriate to introduce changes beyond this sector;
- The underlying problem in the banking sector lay with the IFRS accounting model which allowed banks legitimately to overstate profits which then increased the problem as higher profits facilitated more lending under the capital adequacy regime. This reporting of overstated profits allowed dividends and bonuses to be paid which eroded capital. Capital was further eroded by the need to make much higher provisions for overstated assets as the risks in the portfolios became more apparent. Sadly this was missed by the regulators.

Suggestions about change:

- A clear definition of what is a realised profit for the purpose of the payment of dividends and profit related pay for employees and directors needs to be agreed in the UK at the earliest moment. The IASBs's replacement for IAS 39 is disgracefully late and we cannot wait years for a board which spends its time debating how many buckets go on a pinhead with the US FASB, before we can resolve capital maintenance issues in UK banks;
- As a balance sheet is supposed to be decision useful and represent future cash flows, we should be asking financial institutions to produce their predicted future cash flows arising from their balance sheets, under a safe harbour provision. Whether prudence remains in accounting or not, we could find prudence returning to balance sheets quite rapidly if it became apparent that institutions were subject to market criticism for seriously overstating their cash flows. I have never quite understood the analyst forecast game played between companies and analysts , where a third party predicts a company's performance instead of the company itself;
- If future cash flows were disclosed, this could greatly assist the recognition by stakeholders whether a company is a going concern or not;
- The relationship between IFRS and UK company law is not entirely clear. As this can impact on going concern, this needs to be sorted out and finally clarified as soon as possible;
- From a UK perspective, we need to bring in the principle of economic substance into accounts and ask directors and auditors to confirm that the accounts do show the economic substance of the business. If an override of accounting standards is necessary to achieve economic substance this should be acceptable as a norm;
- Useful disclosures would be the terms of any lending or borrowing covenants;
- More process and rules are not the answer. Whatever is brought in should treated on the one in and at least one out principle;
- SOX in all its complexity did not prevent the next major crisis.

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