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The Sharman Secretariat

c/o Financial Reporting Council

Aldwych House

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London WC2B 4HN

30th June 2011

Dear sir,

Thank you for inviting me to give evidence to the Sharman Inquiry.

I have served as Chairman of a number of audit committees, including Hong Kong Telecom(1997-2000) and Aegis Group plc (2002-5). I am currently Audit Chair at Transcom Worlwide sa (since 2010),Synergy health plc (since 2005) and British American Tobacco plc (since 2005).

I consider my recent experience at BAT most relevant to the Inquiry

Accordingly, I enclose a response prepared by BAT , with which I concur, which BAT is happy to be treated as a corporate submission.

Please do not hesitate to contact me if I , or BAT, can be of any further assistance. My email is robert@lerwill.com and my best phone number is 07770586405.

Yours Sincerely

Robert E Lerwill

SHARMAN INQUIRY – CALL FOR EVIDENCE

Going concern and liquidity risks: Lessons for companies and auditors

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?

   A full assessment of a company's going concern and liquidity risk requires a view on the framework within which liquidity and financing is undertaken in the company, the available cash resources and calls on those resources (cash-flow, facilities and access to capital markets) as well as the risks to those cash flows.

   Our current disclosures related to going concern and liquidity risk are very broad, from primary statements and accounting notes to the Business Review and, within that, the Financial Review. The Group's business activities, together with the factors likely to affect its future development, performance and position are set out in the performance and strategy section and the Regional review, while the financial position of the Group, its cash flows, liquidity position, facilities and borrowing position are described in the Financial Review. The metrics used within the finance policies and principles, including target maturity profile, maximum annual refinancing, rating target or other financial metrics, are disclosed in sections on liquidity and interest rate risk management within the Financial Instruments note (note 24). In addition comprehensive disclosure of the cash and debt position including the maturity profile and key facilities are contained within the cash and borrowings note (note 21). The management of the risk to cash and other resources to counterparty risk is also disclosed, and financial risks are addressed in the section on Key Group risk factors.

   In summary, the disclosure in the area can be seen as full and broad. Although its elements are spread throughout the IFRS financial statements and narrative (MD&A), these are drawn together by providing appropriate cross-references in the Going Concern Statement, as recommended in the current version of the Guidance on Going Concern. We consider this to be an appropriate means of bringing together each of the relevant elements, while avoiding unnecessary duplication.

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?**

   Clearly the annual and the half year interim corporate reports form the core of the company's disclosure to the market place, supplemented by the quarterly interim

management statements. The former includes a comprehensive risk assessment, business review and financial disclosure which provide the necessary information for the assessment of the company's historic performance and current financial situation. In addition the company's management meet with investors and hold question and answer briefings around these reporting dates. These take place within the overall reporting and disclosure framework and are not designed to replace or supersede it.

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?

In any area of regulation, in assessing whether a change is required it is first necessary to be clear on whether there is a problem that needs to be addressed and, if there is one, why it is not adequately dealt with by existing requirements. As with all requirements, it may also be that any problems are not with the regulations but whether they are effectively implemented. However, it is not clear what problems exist that mean further changes are necessary.

Moreover, especially given the events that led to the previous changes, any assessment of what further changes if any are required may need to differentiate between the issues more relevant to financial institutions, such as banks, and those faced by non-financial entities. We have seen this problem in IFRS where a 'one size fits all' approach can result in excessive disclosures that do not help and may hinder the benefit to users e.g.IFRS7.

This is related to the issues raised for example by the FRC report on 'Cutting Clutter'. Extending the content of financial reporting requirements in response to a perceived need to respond on an issue, especially when only relevant for some entities can, in the current climate, lead to excessive boiler-plate disclosures which only serve to muddy the key messages. Furthermore the annual report and accounts should not be the default medium when considering whether entities should address specific issues.

The nature of financial statements is principally to be a record of past performance and stewardship, rather than forward looking, although of course the information should help users in their assessment of future trends for the business. However, any forward-looking information needs to be sufficiently covered by 'safe harbour' provisions and not stray into areas of commercial sensitivity.

For many companies the key disclosures are already covered in their IFRS financial statements and narrative (MD&A) reporting. However, it is sometimes the case that the volume of disclosures can make it difficult and time consuming for users to pick up the key messages. However, these can of course also be highlighted through summaries in the MD&A with appropriate cross-referencing (as is done in the going concern statement) and investor presentations.

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?

In terms of IFRS measurement and recognition for non-financial entities the financial statements give a reasonable view of the entity's performance and position for users to take as a base for their assessments. This does presuppose the continuance of a mixed measurement model, with appropriate disclosures, where fair value is largely only applied when consistent with the business model.

There are of course some areas of IFRS that do not lead to helpful information e.g. deferred tax, cash rather than net debt focus, IFRS7. Also a general issue in connection with IFRS is possible divergences between internal and external reporting. Blanket requirements that drive them apart make the financial statements divergent from the business model and leads to additional non-GAAP measures being disclosed. Whilst costly for companies (and thus shareholders) as well as potentially confusing for users, these can help improve the understanding of a company. However, it is difficult to believe that in most cases any of these issues will be material in distorting the view of going concern or liquidity that is the scope of this consultation.

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?**

The processes untaken by directors in making their assessment of a company as a going concern have their basis in the financing and planning policies and practices of the company. Rather than these processes and policies leading to a going concern assessment they have been implemented within the wider company stewardship structures to ensure that liquidity is strong and that the going concern position follows.

The key inputs therefore include:

The annual budgeting and strategy review and cycle. The position of the group and industry is assessed and the group budget for the immediate future is debated and

approved. The budgeting process involves individual business unit debate and review as well as macro stress testing for foreign exchange and similar risks.

Financing and treasury policies. The policies include a set of financing principles and key performance indicators. These are designed to minimise risks to the group's capital structure and liquidity whilst supporting the development of the group and hence the organic profit and loss and cash flow. They are underpinned by a view on the appropriate rating for the company and the required access to global debt capital markets.

Financing plan. An annual financing plan is presented to the Corporate Finance Committee chaired by the Finance Director setting out the group position in terms of bank facilities, access to the capital markets and the required activity over the next 12 to 24 months. A version on this paper is also made available to the audit committee when making their going concern assessment.

Reporting. Ongoing reporting and forecasting including quarterly profit and cash flow forecasts and commentary and a rolling 18 month cash flow forecast.

Given these core inputs into a continuing cycle of review and assessment the process gives a robust view of the company's ability to continue financing and developing its business.

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 process followed when raising capital could potentially involve further due diligence steps, including obtaining additional written confirmation from banks that funding facilities are in place. Where raising additional equity financing, which is fundamental in itself to the financing of the company and/or a particular transaction, the procedures may be enhanced to reflect that risk. For the purposes of routine debt capital raisings via the bank or capital markets, information is usually provided based upon the standard reporting cycle rolled forward for any material events. These procedures are similar to those used in arriving at the going concern assessment.

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?**

The company assesses cash-flow and liquidity on an ongoing basis. Quarterly profit and cash-flow forecasts for the group are prepared, as well as a rolling 18-month cash-flow and liquidity analysis on a monthly basis. These are monitored by the Finance and Treasury departments on an ongoing basis and reported to the Corporate Finance Committee chaired by the Finance Director, quarterly.

These same assessments form the basis of reporting to the Board and are also fed into the going concern and liquidity assessments through the group financing plans and other processes.

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

The company's business is not a notably cyclical one. Annual cycles are captured and monitored through the quarterly forecasting and 18 month rolling cash-flows. In terms of longer term changes to trends these are considered in the annual budgeting and strategy planning cycles

9. **The current model of disclosure identifies three categories of company. What sort of behaviours does this model drive? Is there a different model that might be useful? Would more guidance on the application of the current model be helpful?**

See response to Q12 below.

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?**

The volatility in foreign exchange and credit markets seen over the last few years, 'the credit crisis' have increased the focus on the going concern assessment. Continued access to debt markets could not always be assumed. However, in determining appropriate policies including financing principles and related key performance indicators, an assessment had been made of the impact a sustained closure of the debt capital markets might have. Debating such policies and drawing on experience of the management and directors of the company has highlighted, over the years, key risks that should be considered and the appropriate management and control thereof. The company has therefore been well positioned to meet these risks. A well-diversified funding structure and a sufficient liquidity buffer meant that the company was well placed to deal with these issues.

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?**

The issues raised by this question are for audit firms to comment upon.

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?**

The current FRC guidance emphasises the importance of access to committed bank facilities, with little mention of the use of longer term debt capital markets as an important source of funds. Whilst this is implicit in a model looking largely at the next twelve months where as a backstop committed bank liquidity is vital, this may underplay the importance of the capital markets (bonds and commercial paper) in the longer term financing of a company. As a consequence, the going concern statement is short term in nature, typically only covering the next twelve months, with little mention of the long term certainty of the company's funding and liquidity. This could encourage a short term approach and could underplay refinancing risks.

It is not clear that enforcing a clearer boundary between the three types of company is needed or realistic, as it is rarely so clear cut.