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15 August 2011

Dear Sirs

Comments on and response to the
SHARMAN INQUIRY
Call for evidence

1 **About us:**
The UK Shareholders' Association ("UKSA") is the leading independent organisation which represents the interests of private shareholders in the United Kingdom. We campaign to protect the rights of shareholders in public companies, and to promote improved standards of corporate governance. UKSA is a "not for profit" organisation which is financed solely by its individual members.

2 **Timing:**
We appreciate this chance to respond to this paper even though the closure date has passed

3 **General comments:**
We believe that certain basic assumptions in the paper need to be set in context before various aspects can be usefully addressed.

3.1Press release:
In the press release (FRC PN 34) Lord Sharman asks for views from "representatives of shareholders". It is important to recognise that private shareholders, such as those represented by us, will often have views which differ from those of institutional shareholders, reflecting their tendency to be longer term investors.

3.2 Preamble
All shareholders understand that business carries risks. These can be trading, political, financial and environmental. The question as the whether these risks are such that the business can no longer be considered to be a going concern or to have inadequate liquidity is largely one of degree and judgment. For example small bad debts are common but may not be material. Major political or environmental risks maybe genuinely not foreseeable but can be catastrophic.

By definition anyone running a business is, or should be, an optimist. They always expect to make a profit. The natural and understandable result of this is to take an optimistic view of risk as well and to be most reluctant to admit that they do not have a going concern. It therefore follows that there has to be a process whereby a more sceptical view can be brought forward. Such scepticism needs positive reinforcement by accounting standards which place a clear obligation on directors to recognise risks fully and to take a prudent view of both the likely occurrence of damaging events arising and the likely cost of such events.

IFRS have sought to reduce the level of discretion available to directors in providing for and anticipating risks of loss by insisting that accounts should only recognise losses actually incurred and not recognise those expected (" likely", in the words of the Companies Act 2006[1]) to occur. This requirement has gone along with the demotion of the concept of prudence from being one of the fundamental accounting concepts to a mere aspect of "reliability"[2]. This needs to be reversed. An attitude of prudence should be applied both to the assessment of risk and provision for the losses those risks can reasonably be expected to cause. It can indeed be argued that the drying up of the London Interbank lending market in the summer of 2008 was largely due to mistrust by potential lending banks of the balance sheets of the banks to which they would normally have lent.

4 Introductory paragraphs:
The aims of the enquiry are said to be ensuring that:-
The lessons of the recent past are captured
FRC guidance is developed as necessary, and
Best practice in dealing with a range of related issues is shared widely.

We are concerned that these objectives are in our view both imprecise and inadequately fundamental.
As stated in 3.1 above the fundamental problem has been an unwillingness to recognise that in the real commercial world the dispassionate academic view of accounting is overwhelmed by the natural drive and optimism of commercial management. It is very unclear that this lesson of the recent past has been recognised, let alone "captured". The paper would have stronger focus if it attempted to list what it believed to be the "lessons of the recent past."
FRC guidance needs to address this issue of prudence.

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[1] Companies Act 2006: Provisions are defined in Schedule 7 of SI 2008/209 as "any amount reasonably necessary for the purpose of providing for any liability the nature of which is clearly defined and which is either <u>likely</u> to be incurred, or certain to be incurred but uncertain as to amount or as to the date on which it will arise".
[2] See ASB Statement of Principles which is concerned that "prudence is a potentially biased concept". (Para 3.36). We might respond that such a "bias" can have great value. It may even be essential to counter the inherent bias of some boards towards over optimism.

5 Question 1
We fully support the principle of disclosure. As the nature of risks changes the directors should be required and indeed already are required to identify these changes. For example environmental risk has substantially increased in recent years.
However predictions are inevitably problematical. As suggested in 3.1 above shareholders do in general recognise this and should be put in a position to make their own assessments of "the adequacy of (the company's) capital to withstand potential losses".

We recognise that the term "company's capital" has been extended in recent years away from its traditional definition of share capital and reserves, particularly in connection with banks with the concept of capital tiers. We believe that the definition of capital should be clarified and reinforced and the confusion between substance and form which may be appropriate in a business which is clearly a going concern needs to be supported with a full and clear statement of its real capital- at law.
If this is done there would be no need to consider the "robustness" of the company's capital unless this word is also intended to refer to the amount of capital.

The company's ability to develop its "business model" is a somewhat different problem. It should not be unreasonable for the shareholders to be able to assume that the company will not overtrade.

5.1 Question 2
We have no comment here

5.2 Question 3
. We are not aware of any barriers to the provision of full disclosure other than the reduced requirement to account in a prudent manner.

5.3 Question 4
The central problem with IFRS is the failure to properly recognise the need for prudence in accounting.

5.4 Questions 5-10
These are addressed at companies and their internal procedures and we are not in a position to comment on these.

5.5 Question 11
The auditor has always been required to consider whether the company being audited is a going concern. This is obviously difficult for the auditor who is appointed, effectively, by the very management he may need to disagree with. Procedures such as the appointment of auditors by genuinely more independent means could alleviate this problem. It is understood that arrangements of this nature can apply in Sweden. Another possibility is the use of shareholder committees.[3]

[3] See UKSA booklet of January 2010 "Responsible investing for the individual and for society", page 26. . Available at http://www.uksa.org.uk/ri2010.pdf

5.6 Question 12 Guidance for Directors in respect of going concern risks.
We would not support a requirement to use standard wording when directors report on such risks. Standard wordings tend to be used without proper thought.
The categories of companies which apply when considering going concern appear appropriate to us.

5.7 Question 13
No

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For The United Kingdom Shareholders' Association

15 August 2011