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Dear Sirs

SHARMAN INQUIRY
CALL FOR EVIDENCE
Going concern and liquidity risks: Lessons for companies and auditors

Kreston UK appreciates the opportunity to respond to the call for evidence from the Sharman Inquiry with regard to going concern and liquidity risks.

Kreston UK represents the 12 UK member firms of Kreston International. Kreston International is a global network of independent accounting firms, currently ranking as the 14th largest accounting network in the world. Kreston UK has 34 offices providing a resource of 1300 professional and support staff and, as a combined organisation, would rank in the top 15 UK firms. Our member firms deal with a wide range of clients, from owner managed businesses to fully listed entities.

Key points

Our detailed responses to the questions are set out in the attached appendix. We draw attention to the following key points:

- We feel that there is a lack of consistency of reporting on going concern by both auditors and directors which could be addressed by further guidance. This would also assist to clarify what constitutes mandatory disclosure. In our experience, there is often resistance from directors to incorporate a narrative on going concern in the notes to the financial statements.
- There is a lack of sensitivity from credit rating agencies and banks in their response to going concern issues reported in financial statements. Such stakeholders appear to issue blanket responses when establishing credit ratings or borrowing facilities demonstrating a lack of understanding of the intention of commentary in the financial statements on going concern.
- We feel that increased guidance in respect of the language to use

when making disclosures would be useful, whilst still allowing for bespoke wording to be used when the circumstances require it.

- Clearer guidance in respect of both directors' responsibilities and disclosure requirements would be beneficial. It is our experience that many companies do not undertake a sophisticated evaluation in respect of going concern. As a result, this causes us, as auditors, a problem with regard to limitation of scope.

If you have any questions, please contact Sue Almond (sue.almond@kreston.com)

Yours faithfully
For and on behalf of Kreston UK

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APPENDIX – RESPONSES TO SPECIFIC QUESTIONS

Transparency of going concern and liquidity risk

Q.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?

An approach that requires evaluation of the risk to stakeholders to ensure that the level of disclosure in the financial statements is proportionate to the risk would best enable investors and other stakeholders to evaluate a company's exposure to going concern and liquidity risks.

Q.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?

Our clients' experience here relates to the increasing importance of credit rating agencies whose approach is not transparent and consequently inconsistencies arise which actually result in increased uncertainty.

Q.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?

We have no specific comments to make.

Q.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 consider that greater or increased clarity on the practical application of these requirements would be beneficial.

Company assessment of going concern and liquidity risk

Q.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?

In our experience, a whole range of different processes are undertaken by directors which appear to be more driven by their level of financial sophistication, rather than by the level of risk involved.

Q.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?

We have no specific comments with regard to this question but would suggest that any additional requirements need to be proportionate to the risks involved and the costs of producing and assessing such information.

Q.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 auditors, we see a variety of approaches from our clients when assessing the cash flow and liquidity of the company.

So that approaches to assessing future cash flow and liquidity are consistent, we feel that clearer guidance on directors' responsibilities in this area would be beneficial.

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

We have no specific comments to make in relation to this question.

Q.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?

We consider the categories of company within the current model to be too broad in so far as there is a large gap between 'there are no material uncertainties' and 'there are material uncertainties.' We suggest that there is room to consider a wider range than just the three categories of company within the current model.

We consider clarification with regard to the definition of 'material uncertainties' would be helpful together with guidance in respect of companies who fit into category 1 of the model. We note that companies that fall into category 2 and 3 have disclosure issues, but currently there is uncertainty over whether companies who fit into category 1 have disclosure issues to address.

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Overall, increased guidance for directors and auditors would be helpful.

Q.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?

As auditors, we feel there is a lack of consistency of reporting of going concern by both auditors and directors.

In particular, an issue that has arisen as a result of a heightened focus on the assessment of going concern is a lack of sensitivity by credit rating agencies and banks in their response to going concern issues that are reported in financial statements.

Credit rating agencies and banks appear not to have an appreciation of the subtleties of the language used, which may result in an inappropriate blanket response when establishing credit ratings or borrowing facilities.

In general, we have found that the inclusion of commentary in the financial statements on going concern where there are no material uncertainties is perceived as an indication of concern, which is the opposite of the intention when including such narrative.

We believe standard setters should be sensitive to the words 'going concern' which can raise unfounded concerns with less-informed readers of the financial statements.

Finally, in our experience, many companies do not have the formal means to undertake a sophisticated evaluation when considering going concern. There is a lack of awareness by directors of their responsibilities and the audit implications that arise from it. Consequently, this causes us, as auditors, a problem with regard to limitation of scope.

Q.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?

There would appear to be a lack of consistency by auditors with regard to their approach to going concern, liquidity risk and subsequent reporting. We are concerned that this could lead to 'opinion shopping' by directors.

In our experience there is uncertainty with regard to what constitutes mandatory disclosure and it is frequently difficult to persuade a small company to have a going concern note within their financial statements. Further guidance would be helpful.

As auditors, our approach is guided by whether the Board has met its obligation to consider trading prospects twelve months ahead and being challenging the basis upon which they have been prepared.

Audit work carried out is primarily review based and includes enquiry of the banking relationships and financial headroom available to the company. We have few clients that have Audit Committees, but we make comments to the Board. In general, the work is undertaken at top management level and therefore the Board should be aware of what work we are doing.

The assessment of going concern involves different processes with regard to seasonal businesses.

We feel that greater guidance to auditors (and directors) would be helpful including increased emphasis of assessing and discussing these issues at the planning stage of the audit.

Feedback on the Guidance for Directors of UK Companies in respect of going concern and liquidity risk

Q.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?

We believe that further clarity would be helpful.

In particular, we feel that the status of the guidance could be clearer and could address the current ambiguity of what is mandatory disclosure.

Increased guidance on disclosures and the language to be used would also be helpful but without introducing a 'straight jacket' that restricts the reporting on individual circumstances (for companies within categories 2 and 3).

Guidance in the form of a decision tree, as previously available in APB Bulletin 2006/6 September 2006 would be considered as useful.

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

Our main concern is that there should be greater clarity regarding the response from Credit Agencies in response to going concern issues.

We encourage an approach that results in greater consistency amongst audit firms to going concern and liquidity risks.