Local Authority Pension Fund Forum

The Sharman Inquiry – Call for evidence – Going concern

The Local Authority Pension Fund Forum was set up in 1991 and is a voluntary association of 53 local authority pension funds based in the UK. It exists to promote the investment interests of local authority pension funds, and to maximise their influence as shareholders to promote corporate social responsibility and high standards of corporate governance amongst the companies in which they invest. The Forum's members currently have combined assets of over £100 billion. The Forum has taken the opportunity below to provide our view on those issues which we consider relevant to our activities.

The Sharman Inquiry – Call for evidence - Going concern

This is a very well written, well structured, timely and relevant consultation. The Panel should be applauded for that.

The first part of the response sets out some of the economic reasoning behind the detailed answers to the questions.

1.1 Background – limited liability status

Unless shareholders have unlimited liability, the going concern status of a limited liability entity is always subject to shareholder support (the capital interest) on which creditor support depends. Limited liability status makes a limited liability company an option. Shareholders have the option to take profits and the option to leave losses – in excess of share capital – with creditors.

That predicament has economic implications that have to be accounted for and monitored.

Limited liability status creates a mode of option taking for shareholders (and risk for creditors) that is more complex than merely taking the net present value of all future cash flows as the shareholder interest in a company. Because losses in excess of capital can be left with creditors, investment returns can be maximised by shareholders being selective on taking future cash flows where there has been a capital loss, by taking future business in a new company rather than recapitalising the capital depleted company. From the perspective of an investor (shareholders or creditors withdrawing support) a capital loss only needs to be based on a reasonable expectation that there will be a loss.

A company will not be a going concern:

i) if the creditors perceive that the shareholder interest has gone below the point at which the shareholders no longer have an interest, and the creditors are bearing the loss **that the shareholder is not required in law, nor incentivised economically to fund**. When this happens it is a better proposition to earn a return on new equity in a new venture with future business following new investment, or,

ii) if the company is nevertheless solvent, but it is not achieving a sufficient return on capital in which case it is the prerogative of the members to wind-up or encourage the company to do something about it, or,

iii) if a company is dependent on new capital by way of rights, and a rights issue fails. A rights issue, at a given price, will simply fail if the investment return is insufficient for the cost of capital demanded by the class, i.e. if the perceived value is below the rights price. A rights issue will fail, notwithstanding what the accounts are showing, if the market perceives that losses exist that have not

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been accounted for (overstating assets which contribute to capital understating liabilities which deduct from it)[1].

iv) if there are also forward control and business issues that have an impact on its going concern status:

a. in any case that the company has insufficient control, or direction,

b. if the company loses its customers, markets, or franchise to operate.

On the basis of the foregoing, the strength of the balance sheet is key to reaching the correct opinion on going concern status. On the basis that only the auditors audit the accounts, the veracity of the audited balance sheet is key to reaching the right conclusion on going concern, as are the other factors set out above, including the robustness of the business model.

In summary, if a company needs to attract capital as a result of a material "slug" of unbooked losses arriving suddenly it may trigger insolvency. If a company is not booking trend losses it may be masking the path towards insolvency, or, if a company is leaving out losses of any kind it may be masking sub-optimal returns. In all cases, this deficiency is leading to the misallocation of capital.

1.2 The governance cycle – going concern and the AGM

LAPFF members have structurally large holdings. Reliable audits, should be giving assurance that companies purporting to be going concerns are truly solvent and truly profitable, not insolvent (capital depleted) or heading towards insolvency. Reliable accounts are essential for protecting both long term shareholders and creditors. LAPFF notes that in law the going concern opinion is linked to the corporate governance cycle, one year from the date that the accounts are signed for the AGM, essentially for the period from the current AGM to the next AGM.

If the company is not monitoring its going concern position properly (in law the directors all the time and the auditors once a year, the shareholders at the AGM) the company - if trending towards insolvency without itself knowing it - may find itself suddenly insolvent, unaware of why it cannot raise new debt or equity finance. Essentially the company (the directors and shareholders) will not know why it is not attractive for sustaining creditor funding, or obtaining new equity funding.

Capital depleted companies, may be able to trade in capital markets, for a while on residual hope value, for example tax losses. The presence of a market for shares is not itself evidence of a company being a going concern. Any capital depleted company may be little more than a bet, a traded option whilst not being a going concern.

[1] Rights issues can be "insured" against failure by being underwritten and/or deep discounted. In a climate of unreliable accounts one would expect higher underwriting fees and/or deeper discounts, together with some companies failing shortly after rights issues. This pattern can be observed in recent years.

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1.3 Going concern and accounts

It seems to LAPFF that there are two interrelated issues:

- that audited accounts are sufficient to determine whether the going concern basis is appropriate. Otherwise how do the directors and auditors know whether a business is a going concern?

- the accounting implications of the going concern basis. Making adjustments to assets and liabilities if the going concern basis is not appropriate.

LAPPF would not necessarily put too much emphasis on "users" of the accounts having information to conclude on whether the business is a going concern, for the simple reason, the auditors and directors should have already come up with the right conclusion themselves by looking at the audited accounts. Leaving it to "users" may lead to a drag on the share price whilst the accounts appear fine. In such circumstances not only may the accounts be masking that the company is heading towards not being a going concern, but the company is rewarding insiders and over distributing on the basis that it is profitable when in fact it is not.

If markets are concluding what directors and auditors are not, one would expect price volatility in view of that uncertainty. Whilst some market participants might like volatile, value destroying situations, LAPFF members are long-term holders.

1.4 Appraising a company as being a going concern

1.4.1 The balance sheet and profitability

Because of the loss put option, there is a difference between future profits (which are dependent on continuing as a going concern) and current losses which may threaten going concern status.

LAPFF notes that an auditor signs off on whether in his opinion:

- the parent company is a going concern – the auditor opinion on the parent company accounts.

- the group is a going concern – the auditor opinion on the group accounts.

It is possible for a parent company to be a going concern, even if parts of the group are not, i.e. loss-making but ring fenced subsidiaries, that are not critical to the survival of the parent company.

Conversely, a loss making subsidiary, that the parent company has a significant investment in, has loaned money to, or has guaranteed, may cause the parent company not to be a going concern if a subsidiary is not a going concern.

It is therefore essential in assessing going concern, for the company itself, and its subsidiaries to prepare properly audited accounts, given that a going concern problem anywhere in the group may affect the going concern status of the parent company itself and/or the group.

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LAPFF is therefore perturbed that the FRC has recommended that subsidiaries should no longer require audited accounts, where there are parent company guarantees to the creditors of the subsidiaries. The going concern status of the parent company - which is offering the guarantee - may be wholly dependent on the going concern status of the unaudited subsidiaries in order for the guarantee to be meaningful. The quality of the guarantee itself is dependent on the things that are not audited. The FRC proposal would appear to create both a hazard and an unauditable situation, due to limiting the scope of what is audited. Given that some banking subsidiaries brought down whole groups, this is not a trivial matter, particularly at a time that "ring fencing" risk is becoming a matter of public policy.

1.4.2 IFRS and going concern (question 4)

Several aspects of IFRS does not look at loss risk by quantifying it and reflecting it in the accounts, i.e. it is left out of the P&L and Balance Sheet. These include:

- IFRS does not purport to give a reliable net income figure. That is a major flaw given that only <u>true</u> profit builds or renews capital. Further, for any business model where profits are distributed, to insiders and/or shareholders, that creates a major risk of inappropriate reward/distributions as well, loss recognition - there are several areas where IFRS has overridden the general presumption of loss_recognition and is leaving out losses. Hence, as well as being defective for determining income, IFRS is also defective for determining capital. This has been most publicly controversial in the case of bad debt provisions of banks ("losses no matter how likely are not recognised[2]"), but the problem is relevant in other sectors, and in other standards as well; (e.g. IAS 19, deferred bonuses, relating to the profit pool for the year are not booked despite being claims, or contingent claims on the capital),

  The problem arises because under IFRS, loss recognition is not – unlike in Company Law accounts (UK GAAP) – the <u>universal</u> standard for accounting, hence IFRS is carving out areas where losses may fail to be reported up, not audited, or taken account of,

- duplicate consolidation in the parent company's own accounts of other legal entities, e.g. Master Trusts. As IFRS is a "reporting entity" (not a limited company **shareholder capital**) focussed model, IFRS creates rules for what is consolidated – as "the reporting entity" not merely in the group accounts, but also in the parent company accounts (and /or subsidiary accounts).

  The result being, that a separate legal entity, such as a Master Trust which may have a claim on the capital of the sponsoring company, is treated as if it were one and the same as the sponsoring company. That fails to differentiate the two different legal persons with different capital interests. The financial reporting then fails to account for the transactions between them, and as a

[2] IAS 39 – Para AG 89 AG 90.

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result the accounting fails to take account for the risk that one body of capital might extend a claim that brings down the other.

In the case of Master Trusts, the capital of the sponsoring company is exposed to any residual investment in the Master Trust, and any contingent calls on the capital of the sponsoring company, and IFRS has obscured that.

LAPFF notes that Equitable Life was not a going concern due to the superior benefit to one class of member, at the expense of the other. The “duplicate consolidation” problem of IFRS is doing the same.

1.5 The APB auditing standard ISA 580

The APB auditing standard is generally strong. It is covering many of the risks relevant to going concern. The problem is applying it in practice, if, as with IFRS the accounting framework that the auditor is auditing to, is leaving out losses and risks. This is clearly a problem wherever the auditor is relying on the veracity of the accounts of audited subsidiaries. With IFRS, losses, trend losses, and contingent liabilities are omitted. LAPFF’s answer to the detailed consultation questions, does flag that the APB should consider with some urgency, having a separate auditing standard on holding companies, and on reliance on the audits of subsidiary accounts.

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Question

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?*

The issue is not so much one of disclosure (information supplementary to the balance sheet), as much as properly accounting for capital properly in the balance sheet where a risk is already present or likely (see 4) below.

Given that the auditor in law is passing an opinion on going concern (a clear "message"), not merely a means of conveying information to the market ("a messenger") one would assume that the auditor is taking account of the business model and the ability to finance it. Indeed, the more that the auditor merely ensures that information is "in the market", but the auditor is passive on the matter of going concern, due to a lack of scepticism and proper information on which to base the going concern opinion, the more auditors will appear weak.

The auditor is giving an opinion to the body of members as a class, not capital markets with more sophisticated price discovery mechanisms. 2% of a class being aware of information – which may be sufficient for price discovery – is not the same as 100% of a class being aware of information from the report and accounts in order to exercise rights as a class.

LAPFF notes that there is no auditing standard on auditing a holding company – as distinct from auditing the group. As referred to above, the risk perspective of the holding company, where assets may be intercompany loans and debt, may be different to the risk perspective on looking at consolidated assets. That is particularly relevant to going concern. Shareholders are after all invested in the **holding company** and it is that to which auditors and directors have fiduciary duties.

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?

Prior to banks failing, some broker research[3] showed that Master Trust arrangements gave tremendous protection to note holders. The protection was offered by covenants to the detriment of the capital of the sponsoring banks. Due to the method of IFRS consolidation, this was not disclosed in the accounts and presumably not audited, or seen as a clear going concern risk.

Further, some risks to banks being going concerns could be identified by merely observing business practice. Short-sellers were remarkably good in identifying problems with all of those UK banks which subsequently collapsed. Short-sellers did not put bad loans on the books of banks.If the auditors and directors are not accounting for risks that markets are surmising, auditors and directors are not

[3] Revisiting UK mortgage master trust structures Deutsche Bank, 2008.

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merely misleading themselves but the shareholders, and placing themselves behind events, rather than ahead, on-top and in control.

LAPFF notes that non-banks have their covenants monitored by banks or bondholders. Banks have such fluid funding models that their public accounts are the only tool for all funders (including interbank lending) to be able to rely on. Banks' accounts should be sufficiently reliable to reflect the implicit covenant in the public interest that the auditors are there to protect[4].

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?

The problem with a disclosure based approach is listing things without taking account of them in the balance sheet, and thus the generality and irrelevance of risks listed for the sake of it. The FRC has been strong on trying to weed out irrelevant information. The challenge (see 4 below) is getting relevant risk quantified and booked in the accounts.

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?

There are clearly significant problems with IFRS:

- recognising uncertain assets (unrealised profits and aspects of fair value),
- leaving out losses,
- leaving out likely contingent liabilities,
- a lack of granularity in summation of assets and liabilities (such as the problem with Collateralised Debt Obligations), obscuring losses, hiding gearing,
- duplicate or superfluous consolidation, masking overvalued assets or excluding contingences,
- the core construct that "income" is merely the difference between two rules prescribed balance sheets, even if the outcome is patently not true income,
- but also, providing so much information that the wood cannot be seen for the trees.

LAPFF notes that the pursuit of accounting according to these objectives coincides with a period of market volatility and tremendous shareholder value destruction. This might be expected from any accounting regime which can mask value transfers to insiders based on insubstantial "profits", as well as the masking of general corporate inefficiency.

[4] Audits were first required in law following the fraudulent collapse of City of Glasgow Bank in 1878.

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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?*

Given that primary providers of finance are using the published report and accounts to make their assessment of whether to provide finance, a good place for the directors to end up in assessing going concern should be the audited annual report and accounts. However many qualitative disclosures there are, investment decisions distil down to the numbers. If the directors do not understand their own accounts in the way that rational capital providers will look at them, it is difficult to see how they can properly assess going concern. The same goes for auditors.

The recent FRC statement on capital disclosure is very helpful, however there are some flaws in IFRS that may undermine the veracity of this, by not having capital addressed where it should be, in the balance sheet.

Another key risk to going concern is the level of internal financial control. LAPFF notes that there is no guidance for auditors on applying Section 386 (proper accounting records), but in cases of companies not being going concerns, including latterly some banks, it is clear that record keeping has been defective for the purpose set out in Section 386, which is:

- proper accounts at all times, and,
- proper accounts to prepare relevant accounts (for distributions), and,
- proper accounts to prepare year end accounts on a true and fair view basis, and,
- to comply with Article 4 of the IAS regulation

LAPFF notes that the legal requirement for auditors to form an opinion on control, applies to all of Section 386.

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Given that banks have failed due to being overloaded with bad loans, hence demonstrably failing to comply with points 1, 2, and 3, above, auditors merely pursuing points 4 above will not have been following the full scope of law, despite each part of the legislation being relevant to going concern.

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?

This is an extremely good question. Each year the AGM is assenting to the company continuing for another year. That is the basis on which directors are appointed. In that situation the invested capital is captive, share price movements are indicative of the value of the equity, but the control mechanism is governance, based on the reliability of the information given to shareholders as a class.

In raising new capital, share price movements can be critical to the new issue being successful, as one price is set for the whole class, price discovery may make the issue fail. However, the purpose of a prospectus is not to serve a governance function, the purpose of a prospectus it to prevent value transfers from the subscribers of the new shares to the existing shareholders ("the company")

Therefore – reliable - prospectuses have comprised both annual accounts (stewardship assurance and information) plus more value oriented information (business prospects). However, it is quite clear that new capital has been raised of late with insufficient information in either the accounts, or the supplementary information in the prospectus. Certain banks were not only not going concerns within a year of having a clean audit opinion, they were still not going concerns within months of having then raised new capital. Going concern is a central plank of proper stewardship based on financial governance.

It would seem to LAPFF that due to the accounting regime excluding stewardship objectives in practice in annual accounts this has also undermined the quality of prospectuses. This has led to governance (poor companies undertaking rights issues) as well as market failure concerns (rights issues not standing up within a year of issue).

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?

Again, LAPFF notes that not all cash flows are equal where large losses may be pending, and that there is particular hazard where these are not accounted for:

LAPFF draws attention to Section 386 of the Companies Act 2006, the director duty to keep records sufficient to show with accuracy at any time the position at that time. LAPFF notes that there is no auditing standard addressing that objective, despite an explicit requirement in the Companies Act for auditors to form an opinion on whether directors have discharged that responsibility.

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

This is a very pertinent question. The annual report and accounts should be an opportunity to break management and director "group think" about the business and the viability of its model. If directors are running the business properly, non-viable business should be capable of achieving a "soft landing" rather than ending up in insolvency. This has parallels with board succession planning, but the issue is rather 'corporate succession'.

It is quite clear that some companies, Southern Cross for example, may never have had proper business cycle resilience. The accounts of Southern Cross show that it has been undercapitalised from

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the outset. A relaxed listing regime does not work if the accounting regime is not applying the going concern concept properly.

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?

The disclosures in the financial statements which follow from the directors' conclusion on whether the company is a going concern identify three categories of company:

> *1. Those where the use of the going concern basis of accounting is appropriate and there are no material uncertainties related to events or conditions that may cast significant doubt about the ability of the company to continue as a going concern;*
>
> *2. Those where the use of the going concern basis of accounting is appropriate but there are material uncertainties related to events or conditions that may cast significant doubt about the ability of the company to continue as a going concern; and*
>
> *3. Those where the going concern basis is not appropriate.*

The current model would appear to be sufficient. However, there may need to be explicit clarification that the reliability of the balance sheet is essential to going concern status, and that asset price movements do not have "neutral" risk, it is asset price falls that disturb the going concern presumption.

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 fact that some banks were not going concerns, after, i) receiving clean audit opinions, ii) public issued rights capital, and then iii) government support, is indicative of going concern assessments by directors and auditors not working properly.

It is interesting to note that LIBOR began to rise in mid-2007, a clear indication that amongst banks themselves they were beginning to doubt the credit standing of each other which is a clear sign of insufficient economic capital (that which the market for the provision of finance perceives is capital) whatever the banks accounts were showing.

LAPFF notes that Basle capital requirements on the sufficiency of capital for achieving a solvent run off, i.e. to absorb losses in the event that the bank becomes a non-going concern. That is objectively different to capital required on a going concern basis, and requiring appropriate accounting in order to report losses, or trends towards loss. The shareholder interest is met by identification of losses rather than building up capital to absorb losses that the accounting (and audit) is not picking up.

There is also an interaction with the law relating to the ability to pay dividends lawfully (rather than out of capital).

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?

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Again, this is a very pertinent question. Company Law is clear that where a company has undertakings that fall outside of the scope of UK Company Law that the rigour of UK Company Law must apply (Section 366(1)(5)) so that any accounts required to be prepared under the Act comply with the Act – which is all 2 aspects of Section 386. The way that the law is structured is absolutely clear, that auditor merely receiving information in an IFRS form is not sufficient.

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?*

In view of some of the comments above, a clear articulation of the law by the FRC would seem to be very beneficial, as would a proper accounting standard on going concern.

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

In view of some of the comments above, a clear articulation of the law would seem to be very beneficial. It would seem to be there for a purpose, but is not necessarily followed objectively, not least due to auditor related defence issues.

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