THE SHARMAN INQUIRY : GOING CONCERN AND LIQUIDITY RISKS

CBI RESPONSE TO CALL FOR EVIDENCE JUNE 2011

I EXECUTIVE SUMMARY

1. The Confederation of British Industry (CBI) is pleased to make this submission to your Inquiry.

2. First of all, we wish to emphasise the CBI's strong support for the existing FRC Guidance on Going Concern and Liquidity Risk published in November 2009. A large measure of this Guidance was developed out of the Update for directors of listed companies published in November 2008 at the height of the financial crisis. The CBI greatly valued its involvement in the FRC processes leading up to these publications, which has provided very valuable assistance to companies and their boards.

3. The existing guidance does therefore seem to have worked well and to be well regarded, although it is appropriate to keep it under review and update it at intervals as appropriate. Accordingly the CBI has few major issues to raise in connection with this Inquiry, although we offer the following observations which may be helpful.

4. First, we wonder if more should be said in IFRS and in the IASB's Conceptual Framework on issues and guidance relating to Going Concern. After all going concern is an issue for all businesses worldwide, and not something peculiar to the UK.

5. In this context, it may also be relevant to re-consider whether the principle of prudence should be a fundament concept of financial reporting, and be part of the Conceptual Framework. This was rejected by the IASB when issuing revised Chapters 1 and 2 to the Conceptual Framework in September 2010. The IASB argued that prudence was inconsistent with the principle of neutrality, and if financial information is biased in a way that encourages users to take or avoid predetermined actions, that information is not neutral. However a lot of respondents, including the CBI, were not convinced by this argument, which the IASB acknowledged.

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6. There is also an issue as to whether the UK regime on the review period that directors have to consider in making their going concern assessment should be harmonised with IFRS. Under the UK regime the minimum review period is 12 months from the date of the board's approval of the financial statements whereas the period under IFRS in IAS 1 is 12 months from the balance sheet date. This is also the review period under US regulatory requirements. Even if it is considered that the UK approach is more appropriate, it is not helpful that the UK is out of line internationally, and perhaps the FRC and the Government should seek out some international harmonisation on whatever basis is considered most appropriate. This may be an issue for IASB's Future Agenda consultation expected later this year.

7. Secondly, audit committees are crucial in overseeing and being satisfied with the company's going concern status, liquidity and risk exposures, and with the quality and reliability of the company's reporting processes and output, including in particular the annual report and accounts and the company's accounting policies. Some suggest that auditors should provide shareholders with some form of explicit assurance that they are satisfied that the directors have exercised due care in making their going-concern assessment and other judgements. However companies are concerned that this will unjustifiably adds to audit costs, when directors and the board as a whole have their own legal and fiduciary duties and responsibilities in this regard.

8. We do not think that the current model of going concern assessment is broken, particularly having regard to the severity of the financial crisis, and with the aid of the current guidance referred to above. The position of the banks can be regarded as something of a special case, as illustrated by the report of the recent House of Lords Inquiry into the audit market, and the references to the implicit (or it seems even explicit) Government guarantees that underpinned auditors' reports on certain banks.

9. Thirdly, however, we believe that this Inquiry could contribute to a broader dialogue on the requirements for reporting by companies on risks, liquidity and funding, and help inform the Government's review of narrative reporting and how the information about the company and its business can best be presented in the company's annual report and elsewhere. However there is no one size fits all combination of information about risk, liquidity and financing of the business that suits all companies. This will vary according to business model and business sector.

10. If it is considered that there is an "expectations gap" amongst shareholders and investors in relation to what going concern represents and, more crucially, what it does not represent, then making this clearer either in the FRC guidance or in information on the FRC website could be considered. Neither companies nor auditors can provide certainty about the future, nor can they predict risks that are not yet foreseeable.

11. We comment further below in response to many of the specific issues on which evidence is requested.

II RESPONSE TO CALL FOR EVIDENCE 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?

The annual report requirements include a statement made by directors that the business is a going concern, together with supporting assumptions or qualifications as necessary ; a description of the principal risks and uncertainties facing the company and a description of risks relating the financial instruments, liquidity and borrowing facilities. These disclosures, while scattered through the front half of the annual report and the financial statements, appear to be fairly comprehensive and are being further supported from 2011 by more information on the business model and financial capital management.

Whilst there are already significant disclosure requirements on going concern and liquidity, as part of the current reviews of narrative reporting and cutting clutter, it may be for further consideration how this information is best presented in a company's annual and other reports.

One also has to have to regard to the need to be proportionate and balanced in making going concern and liquidity disclosures and statements if they should send inappropriate alarm messages causing banks to unreasonably withdraw facilities or suppliers withholding supplies or credit, of which they have been some instances in the aftermath to the financial crisis.

We would also comment that, whilst this question is concerned with the robustness of a company's capital, the most important element in relation to going concern is cash. Companies fail mostly because they run out of cash, and when bank facilities are withdrawn or are not renewed by the bank. Capital is important for banks and financial services firms, but for other businesses monitoring of the cash position and maintaining adequate financial headroom are the most important factors.

It may be appropriate for further guidance to be issued on what constitutes capital, as it seems that individual businesses have a number of different practices and approaches.

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 ?

The FSA Listing Rules and Disclosure and Transparency Rules require prompt disclosure of information, which can include profit warnings and other financial difficulties.

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 do not believe so, having regard to existing legal and regulatory requirements.
That is also a key purpose of the existing FRC guidance, which can be kept under review, and updated at intervals as appropriate.

As noted in response to Q.1, it is important for disclosures to be proportionate and balanced if they are not to cause companies to send inappropriate alarm messages to their bank and other suppliers of credit, and to their suppliers, of which they have been some instances in the aftermath to the financial crisis.

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?

See our earlier comments on IFRS in the Executive Summary above.
As mentioned in response to Q.1, further guidance on what should be regarded as capital may be helpful.

<u>**Company assessment of going concern and liquidity risk**</u>

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?**

We believe that the processes undertaken by directors have been significantly extended both in the rigour of the process and in its frequency following the financial crisis and subsequent economic downturn and since the FRC's updated guidance in October 2008.

We understand that for most company boards a board or audit committee paper will be prepared outlining the annual assessment of going concern. This will include information on the business outlook, cash flow forecasts for at least a year and perhaps 18 months ahead, commentary on funding and net debt, and some form of downside sensitivity analysis.

Boards of companies and their audit committees that are cash rich or well funded will generally need to spend less time discussing and documenting the assessment of going concern.
Clearly where there are financial difficulties and financial concerns, and significant risk exposures which may impact, much more time will need to be spent by the board and its audit committee, including taking professional advice.

More developed financial models and cash flow forecasts have been developed by companies, and are also more extensively used by banks and other providers of credit in their lending decisions.

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?

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 ?

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

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 believe that the current three-category model used for financial reporting and auditing of going concern has worked well. It is well understood, and in cases where there are material uncertainties, it drives appropriate disclosure of the company's circumstances in the financial statements. Boards of directors are mindful of their statutory and fiduciary duties.

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 noted above**,** increasing legal and regulatory requirements, and the developing provisions of Governance Codes and Guidance, and not least companies own experiences during the financial crisis and on-going economic downturn, have rightly led to increased focus by companies and all stakeholders on issues relating to Going Concern and Liquidity, including improved risk management and risk reporting by companies.

Changes in the attitudes and requirements of credit insurers are also a factor.

The auditor’s approach to going concern and liquidity risk

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?

The auditor’s approach will first and foremost be driven by audit professional and ethical standards, and associated guidance.

A key element for the auditor is having a good knowledge and understanding of the company’s business, its financial position and sources of funding, along with appropriate and effective relationships with its board and management, including the audit committee.

The audit firm should then be in a position to discharge its responsibilities, including in relation to Going Concern.

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?**

As noted above, we believe that the existing Guidance has worked well, and we have no further recommendations or suggestions for change beyond our comments above.

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

No.