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08 July 2011

Dear Sir

Sharman Inquiry – Call for Evidence
Going concern and liquidity risks: Lessons for companies and auditors

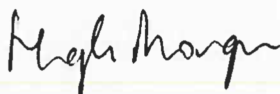
Thank you for the opportunity to contribute evidence to Sharman Inquiry on going concern and liquidity risk.

In our opinion, the UK auditing and reporting regime in relation to going concern is well established and is already more advanced and more rigorous than procedures adopted in many other countries. It is therefore important that the Sharman Inquiry acknowledges the strengths of the UK regime and focuses carefully on where it might need improving.

In our responses to the detailed questions in the "Call for Evidence" we have identified a number of areas where we believe the Panel should focus its attention. Our main concern is that the Panel's review should concentrate on the quality of the information provided to investors and other users of financial statements and attention should be paid to improving the transparency of the disclosures made by the directors about liquidity risk and going concern uncertainties not revision of the auditing requirements which in our experience are fit for purpose.

Please contact me should you wish to discuss any of the points raised in this response.

Yours faithfully



pp Jane Bleach
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Appendix

Response to specific questions asked by the Sharman Inquiry

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?

    In the UK Listed companies are required to include a statement made by the directors that the business is a going concern, together with supporting assumptions or qualifications as necessary. The Companies Act 2006 requires UK companies to include a description of the principal risks and uncertainties facing the company and IFRS and UK GAAP require a description of the risks relating to financial instruments, liquidity and borrowing facilities. Auditors in the UK have detailed guidance on their audit responsibilities with respect to going concern in ISA (UK and Ireland) 570 "Going concern", APB Bulletin 2008/10 "Going concern issues during the current economic conditions" and in October 2009 the Financial Reporting Council ("FRC") specifically addressed the responsibilities of directors in its publication "Going and concern and liquidity risk: Guidance for directors of UK companies" ("FRC Guidance").

    In our opinion, the UK audit procedures on going concern are well established and are already more advanced than in many other countries. The UK has adopted clarified ISA 570 on going concern and the FRC/APB responded to the 2008 economic crisis by issuing guidance to auditors that goes further than the requirements of the ISA. There is little evidence to show that the audit guidance is defective or should be revised. There are however a number of areas where we would question whether current UK practice does enable investors and other stakeholders to evaluate the going concern and liquidity risks that a company is exposed to. We would like the Panel to consider the following points:

    - ***Risk and going concern disclosures*** – in our opinion going concern and liquidity risk are primarily financial reporting disclosure issues and in our experience these disclosures by directors tend to be scattered through the other information in the front half of the annual report and financial statements with very little attempt made to provide any linkage between the liquidity risks and going concern. Although in many cases these disclosures may be fairly comprehensive we question whether, because of the scattered nature of the disclosures, a reader of the financial statements can gain an understanding of the risks relating to going concern and how these risks

affect the company. **We believe that there is scope for improved linkage of disclosures relating to risk and going concern and that a more joined-up approach to risk and going concern disclosures would help a reader of the financial statements to understand where there are risks relating to going concern and how serious those risk are.**

- ***Disclosure of uncertainties*** – We have found the FRC Guidance very useful and have drawn it to the attention of our clients to remind them of their responsibilities. However, in our experience while directors are more receptive to making disclosures about going concern and acknowledge their fiduciary responsibilities they are very reluctant to make detailed disclosures about going concern in line with the examples included in the FRC Guidance. In particular, directors are very reluctant to refer to going concern issues as "material uncertainties" as envisaged in the FRC Guidance because of how they feel that the words "material uncertainty" will be interpreted by the market and their finance providers.

  This has the overall effect of making the going concern disclosures appear very bland rather than being transparent about the particular risks and uncertainties that the company is facing. Too often it is left to the auditor to draw attention to material uncertainties through including an emphasis of matter paragraph in the auditor's report and auditors are put under pressure to dilute the references in the audit report to "material uncertainty" and "significant doubt". It is to the credit of the auditing profession that auditors have in the main held the line and used the suggested APB wording to describe a material going concern uncertainty. We have come under pressure because the emphasis of matter is still seen in some circles as a "qualification" and in many cases it is the only place in the annual report that the words "material uncertainty" will appear. **In our view, the directors disclosure of uncertainties should be improved and we recommend that the FRC guidance is strengthened so that where there are material uncertainties about going concern directors are required to describe in detail what the material uncertainties comprise and clearly describe them as "material uncertainties" rather than adopting a bland reference to going concern that may be misinterpreted by a reader of the financial statements.**

- ***Focus on "capital"*** - The question above focuses on information about the company's "capital" and we question whether this is the right focus for the call for evidence on going concern. In our experience, other than companies involved in financial services, company failures are due to the company running out of cash, failure to agree new bank finance or where existing bank finance is withdrawn following a covenant issue or a breach. In our opinion, the issue of sufficient cash to run the business on a day to day basis is much more important than running out of capital or because the company is incurring trading losses. In many companies it is the monitoring of their day to day cash position and the maintenance of adequate headroom in their facilities that is the most important factor in running the business as a going concern rather than capital or losses and it is important that a reader of the

financial statements understands the risks relating to those areas which may be less apparent in disclosures that concentrate on robustness of capital and ability to withstand losses. **Whilst we recognise that it is important to be balanced and proportionate we recommend that going concern disclosure requirements are enhanced so that more information is disclosed about the factors that really impact the ability of the company to continue as a going concern such as the sensitivity of the cash position and financial headroom. Capital disclosures are clearly important but we recommend that there is clearer guidance about what constitutes capital because businesses currently adopt different approaches to these disclosures and this does not help a reader of the financial statement to understand any concerns.**

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 UK Listing Rules and Disclosure and Transparency Rules already require prompt disclosure of information such as profit warnings and other financial difficulties being experienced by listed companies. Often these disclosures flow back into the risk and uncertainty disclosures made in the annual or interim statements and help inform those disclosures. Although we acknowledge the importance of requiring listed companies to make these disclosures there is no similar requirement for unlisted companies to make public disclosures about the current stresses being experienced by the company and about the management of those stresses outside the normal annual reporting process. Too often this means that unlisted companies do not pay attention to going concern risks during the period in between audits and too much pressure is then placed on the disclosure in the financial statements and wording of the audit report included in the annual accounts because this is the first notice given of any issues with regard to going concern. Often when a company is in financial difficulties the preparation and audit of the financial statements gets delayed and suppliers may be the last people to know when the company they are transacting with is in difficulties. **We recommend that a similar early warning process be introduced for unlisted companies so that banks and companies that trade with the company are aware of going concern issues at an early stage rather than when it is too late to take any action.**

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 our opinion, one of the main barriers to companies providing full disclosure of the risks associated with going concern and liquidity is the over-reaction of banks, customers and suppliers and other users of the financial statements to what they perceive to be "bad news" about the company's ability to continue as a going concern. Directors are reluctant to make disclosures about going concern, particularly any disclosure about material going concern uncertainties, because they fear that the reaction of those reading the financial statements will make these disclosures a self fulfilling prophecy. Similarly, despite the emphasis of matter specifically stating that the auditor's opinion is not qualified, directors do not want auditors to issue an audit report with an emphasis of matter on going concern because they believe this is perceived by the market as a qualification and will only make the company's problems worse.

As noted above, in our view, companies should be encouraged to give fuller and more transparent disclosures about going concern and to refer to "material uncertainties" and link the going concern and liquidity risk disclosures. If the users of financial statements had a better understanding of the meaning of those going concern disclosures and of the auditor's role in drawing the reader's attention to those disclosures this might encourage directors to be more transparent about going concern uncertainties. **Auditors and directors already have detailed guidance on going concern reporting and, in our opinion, it would be helpful if the FRC could help educate users of financial statements so that there was a better understanding of going concern disclosures and the roles played by the directors and auditors.**

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?**

   IFRS disclosures about capital management and the risk relating to financial instruments are covered in IAS 1 and IFRS 7 but the disclosures relating specifically to going concern under IFRS are very limited. In the UK, the FRC has issued its guidance to directors on going concern and liquidity risk and this goes further than what is currently required under IFRS. It is important to maintain the international consistency embodied in IFRS and we feel that the IASB would benefit from following the lead set by the FRC. **We believe the FRC should encourage the IASB to include going concern in its agenda for forthcoming projects and that the IASB should produce guidance on the disclosure of going concern and liquidity risk. This would help ensure that there was some consistency over the disclosure requirements relating to going concern and avoid the scattered approach to going concern and risk disclosures that we noted in our response to question one above.**

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?**

In our experience, there is a wide variance in the approaches taken by companies to the assessment of going concern and liquidity risk, the rigour with which this assessment is performed, the type of risks considered and the documentation of that assessment. In many cases this variation is consistent with the size and complexity of the business, whether or not the company is listed, the business in which the company operates, the experience of management and the demands of the company's finance providers.

Since the recent economic crisis there has been a vastly increased focus on bank covenant compliance and we have seen that companies now pay much more attention to cash flows and the headroom offered by their bank facilities. This can be counter-productive and we have found that companies can focus too much on the short term day to day cash management so that the preparation of detailed cash flow forecasts necessary to support the preparation of the financial statements on a going concern basis is often only done at last minute in response to a request from the auditor. In our experience few companies outside the listed sector have fully integrated financial models and in some cases companies are unable to prepare forecasts supporting the preparation of the accounts on a going concern basis. In our opinion, sophistication of the forecasts prepared and the level of work undertaken by directors in this area should reflect the level of risk involved and the particular circumstances of the company and we would not be in favour of the FRC introducing prescriptive rules.

One area where we consider the FRC could encourage companies to improve is in the preparation of forecasts looking forward a minimum period of 12 months from the intended sign-off date of the financial statements. In the majority of cases cash flow forecasts are only prepared for 12 months following the year end and are only updated at the request of the auditor. Another area where we consider the FRC could encourage the directors to improve is in the stress testing of those forecasts through sensitivity analysis. This is often overlooked until the time of the audit and can often highlight potential going concern issues that had previously been overlooked.

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?**

In our opinion, the level of work and documentation involved when the directors are raising capital and making a working capital statement exceeds that required for the purposes of preparing the annual financial statements on a going concern basis. A working capital statement requires a higher level of assurance than given in annual financial statements and whilst the nature of the procedures undertaken and the documentation produced to support the going concern assumption is similar the level of detail required for a working capital statement is significantly different. A working capital statement containing caveats about going concern uncertainties and an emphasis of matter regarding going concern would almost certainly be rejected. However, the higher assurance about going concern needed for a working capital statement results in higher costs to the company concerned not just because of the additional audit work but also in terms of additional banking and arrangement fees to ensure that committed facilities are in place. **For these reasons we consider that it continues to be appropriate for there to be a distinction between the review of going concern when raising capital compared to the annual going concern assessment undertaken for accounting purposes.**

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 noted in our response to question 5 above, depending on the particular circumstances of the companies involved, there is a wide variance in the approaches taken by companies to the assessment of going concern and liquidity risk. More sophisticated companies who are often required to issue interim reports generally have better procedures to assess future cash flows and liquidity on a regular basis throughout the year and would adopt the same procedures for the full year and interim reports. Other less sophisticated companies may have funding arrangements that require them to report monthly or quarterly on

covenant compliance and have developed systems to enable them to report more frequently and often in more detail than might be required for an annual or interim assessment for the purpose of preparing financial statements. Companies who are relatively cash generative and have no external funding pressure may see little value in assessing future cash flows and liquidity on a regular basis and therefore may only do so at the request of their auditors. **In our experience, where there is an external driver for companies to issue interim reports or to prepare cash flow forecasts to meet particular covenant requirements for funding purposes companies will assess future cash flows and liquidity on a regular basis throughout the year. In the absence of these external drivers there is little need for companies to perform more regular reviews of future cash flows and liquidity. In our response to question 2 above we recommended that an early warning process could be introduced for unlisted companies so that banks and companies that trade with the company are made aware of going concern issues at an early stage rather than when it is too late to take any action. Other than this suggestion for an early warning process we would not recommend that the FRC mandates more regular reviews of future cash flows and liquidity because these are already in place where required by external drivers.**

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

The term "natural business cycle" is undefined and could be subject to a variety of interpretations. Some companies do assess the high level viability of their business over a much longer period than that required for the purposes of assessing whether their annual financial statements should be prepared on a going concern basis. This varies from company to company but in many businesses it is difficult to assess future cash flows with adequate certainty beyond the 12 month assessment required for annual accounts preparation purposes and companies generally do not attempt to go further. In our experience, companies often only prepare forecasts looking forward 12 months from the balance sheet date but can usually extend this to 12 months from the date of sign off to meet the requirements of auditors in the UK. **In our view forecasts only covering on 12 months from the balance sheet date are not suitable for audit purposes and we recommend that the FRC works with International standard setters to improve consistency and to ensure that directors are required to look ahead 12 months from the financial statement sign off date rather than the balance sheet date.**

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?

In our opinion, the current three category model has worked well in recent years and has helped to improve directors' consideration and disclosure of going concern and liquidity issues. As stated in our response to question 1 directors are still reluctant to use the words "material uncertainty" when describing going concern issues and so their disclosures often fall short of the clarity envisaged in the disclosure shown in example 3 of the FRC Guidance. Our experience following the economic crisis in 2008 is that generally directors are now more aware of their fiduciary responsibilities and are more willing to include additional going concern disclosure in their financial statements. As noted above, there is still concern how disclosure about "material uncertainties" and the inclusion of an emphasis of matter paragraph in the audit report will be interpreted in the market but there is generally more acceptance of these matters. **Overall, as noted in our response to question 1 above, we question whether current UK practice does enable investors and other stakeholders to evaluate the going concern and liquidity risks that a company is exposed to. As a result we believe that the FRC should encourage directors to improve the linkage of risk and going concern disclosures and strengthen the guidance to directors so that it requires directors to make more transparent disclosures about going concern risks and uncertainties.**

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?**

In our view, the global economic crisis in 2008 has resulted in heightened focus on the assessment of going concern. Prior to the crisis there had been a period of relative prosperity with plentiful sources of finance and rising property prices and no-one could have foreseen the impending crisis. The level of scrutiny that companies, banks and auditors now give to covenant compliance was uncommon during the pre-2008 period when property prices were rising and finance was available. In our experience, companies sometimes signed up to covenants without thinking very carefully about whether they would be able to comply with them because they knew that other sources of finance were readily available if a covenant was breached and in practice banks were very unlikely to call in the finance.

As noted above, it is very different now and banks and finance providers have called in loans and companies have collapsed as a result. It is more important than ever for companies to keep control of their finances. We therefore recommend that the FRC encourage companies to perform more rigorous stress testing of their cash flow forecasts and apply sensitivity analysis to their going concern assumptions. We cannot recommend that companies should plan for the "unthinkable" like another 2008 economic crisis but forecasts should take account of possible changes and disclosures should include enough information for users to make an informed decision about the going concern and liquidity issues that are foreseeable. Risks that previously had not been regarded as major concerns such as the availability of credit insurance and the counterparty risk that a key supplier or major customer could fail are now considered more carefully

and companies should be encouraged to make meaningful disclosures about the risks affecting going concern in their business.

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 auditor's work on going concern is covered by the detailed requirements in ISA (UK and Ireland) 570 "Going concern" and supporting application guidance within that auditing standard. Further guidance is contained in APB Bulletin 2008/10 "Going concern issues during the current economic conditions" as well as in established UK practice. The auditor's approach to going concern is to obtain sufficient appropriate audit evidence about the appropriateness of directors' use of the going concern assumption in the preparation and presentation of the financial statements and to conclude whether there is a material uncertainty about the entity's ability to continue as a going concern. This will typically involve the auditor reviewing and challenging the information used and assessed by the directors when the directors formed their own view on the appropriateness of preparing the financial statements on a going concern basis. We are not aware that post 2008 going concern failures resulted from inadequate Auditing Standards and the recently clarified ISA (UK and Ireland) 570 was not revised as a result of the economic crisis. In fact, although the FRC/APB reacted very quickly to the economic crisis and helpful guidance was issued on a timely basis to both auditors and directors the guidance to auditors merely built on and clarified existing practice rather than introduced changes to the fundamental approach.

ISA (UK and Ireland) 570 paragraph 23 requires that the auditor communicates with those charged with governance (usually the audit committee) events or conditions identified that may cast significant doubt on the entity's ability to continue as a going concern. The ISA states that such communication with those charged with governance shall include whether the events or conditions constitute a material uncertainty, whether the use of the going concern assumption is appropriate in the preparation and presentation of the financial statements and the adequacy of related disclosures in the financial statements.

In the UK we have adopted the internationally consistent clarified ISAs issued by the IAASB which should mean that where there is overseas reporting in addition to UK reporting we work to at least the same standard as an overseas auditor. The only difference might be that we in the UK assess a longer post balance sheet period of 12 months from the financial statement sign-off date rather than just 12 months from the balance sheet date which is allowed internationally. This

approach has been the same for a number of years and in our opiniondoes not cause any practical difficulties.

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?**

As noted above, we consider that the FRC Guidance was both very timely and very helpful in helping to clarify the responsibilities of the directors. Whilst we do not believe that the FRC Guidance needs major revision we think it would be helpful if directors were encouraged to more follow the guidance more closely. As mentioned in the response to question 1 we consider that the directors' views about going concern would be clearer if they were encouraged to explicitly refer to "material uncertainties" and explain what these were rather than leaving it to the auditor's report to draw material uncertainties to the readers' attention.

Another area where we have a specific concern with is in relation to the categorisation of the examples included in Appendix II of the FRC Guidance. Whilst the three categories are clearly defined, we do not feel that the examples are quite so clearly allocated to the correct category. Appendix II example 2 describes a company with uncomplicated circumstances, some exposure to economic difficulties and either a current material bank overdraft or loan and a need to renew this facility in the foreseeable future albeit not imminently. This example is categorised in the FRC Guidance as category 1 *"No material uncertainties that cast significant doubt about the ability of the company to continue as a going concern have been identified by the directors"* which would typically result in an unmodified auditor's report. This is clearly a judgemental area but in our view this type of situation, where the ability of the company to continue as a going concern is dependent on its existing funding being renewed, the renewal decision is within 12 months from the sign-off date and is outside the control of the company, is an example of a material uncertainty that should be disclosed and referred to in the auditor's report by use of an emphasis of matter. In our view, the Appendix II example 2 scenario fits better within category 2 *"Material uncertainties that cast significant doubt about the ability of the company to continue as a going concern have been identified by the directors"* rather than in category 1. **We therefore recommend that the FRC either remove some of the uncertainty from example 2 making it clear there is no "material uncertainty" so that the example fits within category 1 or consider including example 2 as a category 2 "material uncertainty" example which**

would help to support the view that category 2 can cover a wide spectrum of uncertainties rather than just the more extreme example provided.

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

    Whilst we welcome the FRC taking the lead in addressing this issue we do not regard going concern as solely a UK issue and in the current climate where businesses are more international and prepare accounts more and more under international standards we ask that the FRC does not burden the UK audit profession with an onerous and costly approach to going concern. One of the most powerful benefits from the adoption of international standards on auditing ("ISAs") is that we are internationally consistent and it is important not to destroy this international consistency when there is no evidence that the newly clarified ISAs are not working. **As mentioned above we believe that the disclosures relating to going concern should be improved so that a reader can better understand the uncertainties and sensitivities involved and feel that this an area that the Panel of Inquiry should take into account in its review.**