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Dear Lord Sharman

Going concern and liquidity risks: Lessons for companies and auditors

I am pleased to provide evidence to the Sharman Inquiry (the 'Inquiry') and have set out below a brief summary of my views; my responses to the specific questions from the Call for Evidence are set out in the Appendix to this letter.

Distinguishing between banks and non banks

I believe that it is important the Inquiry clearly distinguishes between banks and non-banks in assessing any improvements to guidance in the area of going concern and liquidity risk. As the recent banking crisis has shown, ongoing access to funding, liquidity and capital mean that these risks, and their implications on going concern, differ markedly from the impacts on non-bank entities. It therefore needs to be recognised that it will be very difficult to develop one set of guidance which suits all. A further distinction is that of regulation. Regulatory minimum standards provide the users of the accounts of banks a benchmark against which to assess the strength of a bank's liquidity and capital position both in absolute and relative terms and form their own judgements around going concern risks. Investors may also take comfort from the extensive regulatory supervision applied including a detailed understanding of management's plans in stress scenarios and mitigating actions. This needs to be taken into account when considering the extent of additional disclosure around going concern that is either required or desirable; I elaborate on this further below.

Enhancements made in response to the financial crisis

The severity of the recent financial crisis and the consequent need for government intervention has led banks to further enhance their internal processes for monitoring and projecting their liquidity and capital position. Internally, this has enabled banks to provide significantly more evidence in support of the going concern basis of accounting and on risk matters more generally.

The UK banks have also made significant enhancements to their financial statement disclosures providing greater transparency into the risks they face, particularly liquidity and capital risk, and how these risks are managed. In this regard, the FRC's 2009 Guidance '*Going Concern and Liquidity Risk: Guidance for Directors of UK Companies 2009*' and the adoption by the UK Banks in 2009 of the British Bankers'

Association's Disclosure Code for Financial Reporting have provided a useful framework for the industry to enhance transparency and comparability.

However, despite these recent improvements, a more forward looking view is not generally presented by banks. This is driven by commercial sensitivity and concern that such transparency could lead to unintended and procyclical consequences. For example if results of internal stress-tests were published, as the triggers or thresholds were approached or breached there could be a risk that access to funding and capital markets would be severely restricted, precisely when a bank's demand for such access is most acute.

In the context of stress-tests, we have seen increasing demands from regulators, particularly the European Banking Authority, to put in the public domain the results of regulatory mandated stress tests. It is clear from these exercises that there is a difficult balance to be achieved between maintaining investor confidence in the robustness of the stress tests without the results negatively impacting confidence in the banking system. Banking regulators must therefore be sensitive to the impact of any further transparency on their goals of maintaining financial stability and investor confidence in the banking system.

Improvements to existing guidance

Notwithstanding, I do believe that there is more that can be done to improve transparency and consistency between banks in the preparation of decision-useful financial statements.

I would welcome the Inquiry's focus on enhancing existing guidance to ensure better articulation of the assumptions made by management in their going concern assessments. Further, better comparability could be achieved from locating disclosures relevant to going concern assessment in one place in the accounts. Specifically, given that liquidity and capital risks are only a subset of the risks run by a bank, there may be advantages from building going concern assessments into the risk management report in order that users can understand management's assessment and assumptions in the context of all the principal risks and uncertainties that they face.

I would be happy to elaborate upon any of the matters covered in this submission should you find this useful.

Yours sincerely



Martin Scicluna
Chairman of the Audit Committee
Lloyds Banking Group plc

APPENDIX – RESPONSES TO THE QUESTIONS IN THE CALL FOR EVIDENCE

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 nature and extent of the information required by investors and other stakeholders to evaluate the nature of the risks affecting a business and their potential impact upon whether or not it is a going concern will vary according to the external environment and the financial position of the entity concerned. However, in the case of a bank the FSA requires a certain basic level of information concerning capital and liquidity in order to make their own assessment as to the financial stability of the organisation and the view has been taken that the provision of relevant parts of this information as part of a bank's interim and annual reporting should also meet the needs of users of the accounts. As a result, typically banks provide a granular level of detail on the composition of their regulatory capital base, analyses of funding sources, key ratios and the related risks. These disclosures constantly evolve as market conditions change and the balance of risk changes and the banking industry has introduced a process through the auspices of the British Bankers Association to discuss emerging issues and ensure a consistent and appropriate response by all. For example, in light of the financial crisis an increased focus has been placed on banks' liquidity risk and disclosures in this area have been significantly enhanced to meet the needs of investors.

I believe that this information is effective in providing a clear view of a bank's financial position and its ability to operate as a going concern at the date of the financial statements. However, a more forward looking view including how this position might change in the event of stressed market conditions is generally not provided (see question 3).

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?

Public disclosures addressing the risks faced by banks are generally included in the annual and interim results, where listing rules require the banks to provide an assessment of the principal risks and uncertainties facing the organisation. Further, more granular information on banks' credit risk and capital is provided in the annual Pillar 3 report.

Information addressing current stresses being experienced by banks is made publicly available under a number of mechanisms. The most relevant announcement, in the context of going concern, has been the publication by the European Banking Authority (EBA) of the results of their stress testing of European banks in July 2010. This was accompanied by consequent stock exchange releases by several individual

banks setting out their response and further information to provide investors with context for the results of the stress tests. Further announcements in respect of the 2011 EBA stress tests are anticipated in July 2011.

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?

Existing IFRS support management's articulation of how they manage risk. A key principle inherent in IFRS disclosures is the requirement to provide disclosures that are consistent with the information that is used internally to manage the relevant risks. A more forward looking view is not, however, generally disclosed by banks. This is driven by commercial sensitivity and concern that such transparency could lead to unintended and procyclical consequences. Were banks to publish the results of regulatory driven or internal stress tests there would be a risk that as the bank approached or breached self imposed disclosed trigger points, the ability of a bank to access liquidity and capital markets at the point in the cycle when such access is required would be severely restricted. Of course listed banks will at all times need to comply with the listing rules to provide the market with relevant information in respect of results and prospects.

Better transparency and comparability may however be achieved from locating disclosures relevant to going concern assessment in one place in the accounts. Specifically, given that liquidity and capital risks are only a subset of the risks run by a bank, there may be advantages from building going concern assessments into the risk management report in order that users can understand management's assessment and assumptions in the context of all the principal risks and uncertainties that they face.

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 provide a robust framework for the preparation of decision-useful financial statements and specifically require an entity to disclose its objectives, policies and processes for managing key risks. In addition, given the importance of capital and funding to banks' business models, the UK banks generally highlight these areas as principal risks and consequently provide additional disclosures, including details of the composition and movements in their capital base and details of funding sources. However, as noted previously, forward looking information and the results of internal stress tests is not generally provided.

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?

- (i) Which records and information are referred to in making this assessment?**
- (ii) What type of model does the company use to develop scenarios to stress-test the assumptions that have been made when making this assessment?**
- (iii) What types of risks are included in the going concern assessment: financial, strategic, operational, other? How are these presented in the assessment?**
- (iv) 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?**
- (v) What impact has undertaking the going concern assessment had on the planning and management of the company?**
- (vi) How has the assessment of going concern and liquidity risks been incorporated into other aspects of company stewardship and reporting?**
- (vii) 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 light of the financial crisis, banks have significantly enhanced the robustness of internal going concern assessments and boards, audit committees and risk committees have required more evidence of the assessment. The key elements of the going concern assessment include the following.

(i) An assessment prepared by management which details funding, liquidity and capital under base case and stress scenarios. Information that is relevant to such projections includes:

- Historic loss information to understand the experienced quantum and frequency;
- Details of the current financial position including the amount and composition of the capital base and liquidity portfolio;
- Regulatory capital requirements including a granular breakdown of risk-weighted assets and forecast capital ratios;
- Planned business changes;
- Regulatory and accounting developments; and
- Forecast base case and stressed financial, liquidity and capital positions.

(ii) The internal models used for the going concern assessment are the same as those used by the business for business as usual planning and stress testing.

(iii) The risks included in the going concern assessment include financial, strategic, and economic risks. The critical risk drivers include GDP, interest rates, inflation, unemployment and property prices. Strategic options are tested by analysing the impact of each option upon the base and stressed forecasts.

(iv) The role of the Audit Committee is to satisfy themselves that management have undertaken an appropriate assessment in order to conclude that it is appropriate to use the going concern basis of accounting in preparing the entity's financial statements. In undertaking this work the committee will review and challenge the capital and funding plans, projections and stress assumptions. Board risk committee oversees the development, implementation and maintenance of the overall risk

management framework (including proposed improvements) and risk exposures, and the risk appetite .

(v) Management routinely carry out planning and stress testing of the business plan (including funding, liquidity and capital) on an ongoing basis. This impacts a bank's strategy for growth, capital raising (through market issuance, call options and distribution of profit), funding (through market issuance and lending capacity) and liquidity (through investment strategy). The going concern assessment is therefore an additional run of existing processes specifically prepared to confirm the appropriateness of the going concern basis of accounting.

(vi) Capital and liquidity risks are routinely modelled and reported on an ongoing basis as part of management processes. Therefore the going concern assessment is derived from existing management processes rather than being a driver of management behaviour.

(vii) Internal management processes for managing capital and funding risk including stress testing are important and effective tools in supporting management's assessment of the going concern basis in the preparation of an entity's financial statements.

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?

Fundamentally the process of considering base and stressed forecasts is the same.

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?

Future cash flows and liquidity is a key activity in the day to day running of a bank. This is done daily as part of internal management information and weekly for FSA reporting. Information is provided monthly to Asset/Liability committees and Board.

The base data is sourced from core systems, and is therefore consistent with, and reconcilable to, financial statement disclosures. The method and style of presentation will however differ, with much more detailed, granular information provided internally and to satisfy regulatory reporting.

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

This is undertaken as part of the business planning cycle (typically over 3 – 5 years) with quarterly updates to funding and capital forecasts.

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 consequence of management concluding that there are material uncertainties relating to events or conditions that may cast significant doubt on the ability of the entity to continue as a going concern requires significant management judgement and leads to the external auditor including reference to this uncertainty as an 'emphasis of matter' paragraph in their audit opinion. The implications of such an opinion on investor sentiment could influence the assessment as to whether there is indeed a material uncertainty and further guidance in this area could assist consistency of approaches by companies.

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 recent financial crisis and the consequent need for considerable government intervention in the banking industry has had specific relevance to the banking industry and has led the UK banks to enhance the presentation of evidence supporting the going concern assessment.

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?

It is the directors' responsibility to determine the appropriateness of the use of the going concern basis of accounting, and in reaching this assessment, management will undertake a robust assessment and provide the necessary support.

External auditors review the results of the work undertaken by management, including the assumptions used and the reasonableness of judgements made. The result of their assessment is reported to the Audit Committee.

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?**

The FRC's 2009 Guidance provided a useful framework for banks during the recent crisis. While I believe some enhancement could be made, these should avoid developing boilerplate disclosures and should instead focus on providing disclosure principles that enable individual companies to develop relevant and decision-useful disclosures.

I would therefore welcome the Inquiry's focus on enhancing existing guidance to ensure better articulation of the assumptions made by management in their going

concern assessments. Further, better comparability could be achieved from locating disclosures relevant to going concern assessment in one place in the accounts. Specifically, given that liquidity and capital risks are only a subset of the risks run by a bank, there may be advantages from building going concern assessments into the risk management report in order that users can understand management's assessment and assumptions in the context of all the principal risks and uncertainties that they face. Further guidance in assessing when a material uncertainty exists would be welcomed.