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8 July 2011 **AMENDED VERSION – 11 JULY 2011**

Dear Sirs,

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

INTRODUCTION

The Quoted Companies Alliance (QCA) is a not-for-profit membership organisation working for small and mid-cap quoted companies. Their individual market capitalisations tend to be below £500m.

The Quoted Companies Alliance is a founder member of European**Issuers**, which represents over 9,000 quoted companies in fourteen European countries.

The QCA Corporate Governance Committee has examined your proposals and advised on this response. A list of committee members is at Appendix A.

RESPONSE

We welcome the opportunity to respond to this call for evidence. We have provided responses to the questions below:

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?

Ultimately, transparency on how a board comes to its conclusions on going concern is key in order for investors and other stakeholders to assess going concern and liquidity risks.

For example, the nature and extent of the scenario planning and stress tests to which the board subjects its business model, the key drivers of its balance sheet and cashflow statements, together with a description of the most important and volatile sensitivities, would be useful information.

Ultimately, this would be providing more information about the process of how a board determines its going concern position.

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?**

We do not have any comments on this question.

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 audit report provides minimal information to outside investors and other stakeholders. While the audit process and the interaction with the audit committee, the rest of the board and senior management may reveal useful information provide useful testing of policy and process and help the board in its oversight of the company, none of this is revealed externally. It may be that more information about how going concern and key risks are evaluated and tested would encourage more investor confidence, which is key to the development and growth of smaller quoted companies.

Moreover, the audit merely tests the position of the company at the balance sheet date; while the going concern statement provides for some forward looking thought, the audit process does not generally allow for testing of the direction of the company and any developing tendencies within it.

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?**

The current focus in the IFRS approach on the balance sheet and asset and liability valuations means that much of the attention in corporate reporting, of management, boards and auditors, is in a direction away from what matters for going concern, which is an issue much more about cash flows than asset valuations (at least in companies other than financial institutions).

Thus, raising issues regarding the fair value approach in IFRS is not necessarily the key issue: it is the valuation approach which may distract attention from issues that matter for going concern. Having said this, however, we are not sure that IFRS's focus on valuation should be blamed for going concern failures: management, boards and auditors should be more than able to step away from valuation matters to consider cash flows, their sustainability and their sufficiency to satisfy the financing needs of the business as a going concern. This re-emphasises the need for all three of these parties to have processes to consider going concern separately from normal reporting activities. We believe that such behavioural changes are far more important than any changes to IFRS standards or associated disclosures.

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?**

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?**

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?**

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

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?**

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?**

For Questions 5 - 10, please see our response to Question 3. For many companies, disclosure to outsiders on how the assessments are reached is minimal at best. More information about how companies make their assessments would help encourage better engagement with investors and other key stakeholders.

In relation to Question 9, conversations can focus on how to obtain the 'going concern' opinion rather than a holistic view of the major risks facing the company and how the risks themselves can best be mitigated. This unfortunately means that some boards can become overly concerned with process rather than their role as a steward.

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?**

We are concerned that under the IFRS framework, audit process create conditions where audit firms are overly concerned with meeting the strict legal and regulatory requirements of going concern rather than highlighting to their clients – the shareholders – the major risks that they have identified. For audit to be valuable in relation to going concern the audit should comment on the processes the company has in place to manage its going concern process and identify areas in which it has suggested improvement. If this is a step too far then perhaps the audit committee should be able to make such comments with the external auditor then commenting on their appropriateness (perhaps on a negative assurance basis).

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?**

We note that the *Guidance for Directors on Going Concern and Liquidity Risks* was last revised in 2009 and that the Quoted Companies Alliance was actively involved in the review process and supported the final guidance as helpful.

In terms of amending the guidance, the most recent review was carried out quite recently; as such there may be a need to allow the current version to embed more before attempting to evaluate its effect on going concern statements.

We do not believe that standardised language for directors would be helpful; our fear is that this would lead to even greater boilerplate than is currently the case.

It is possible that the guidance could emphasise more the importance of explaining the complex dynamics that lead the directors to make their statement.

We do not see a need for clarifying the boundaries between the types of companies, as they will always be fluid – directors should, however, be explaining the likely direction of travel of the company in relation to these categories and the sensitivities that might shift a company's course.

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

Our general concern in relation to going concern is to achieve better reporting and transparency on how boards come to a conclusion and any sensitivities that may shift this statement, while at the same time avoiding meaningless boilerplate. As such, we would be sceptical about additional reporting requirements or specific language for disclosures on going concern.

This can best be achieved by companies being better rewarded for good reporting. This process has been started by a number of initiatives, including the ICSA/Hermes Awards, but should continue to be extended to encourage both boards and in particular shareholders to think in a longer term fashion.

If you would like to discuss any of these issues further, we would be pleased to attend a meeting. We would also note that Roger Marshall is attending a Quoted Companies Alliance Corporate Governance Committee Meeting on Monday 11 July 2011 to discuss this review.

Yours faithfully,

Tim Ward
<u>Chief Executive</u>

Quoted Companies Alliance Corporate Governance Committee

Tim Goodman (Chairman)	Hermes Equity Ownership Services
Edward Beale	London Finance & Investment Group PLC
Tim Bird	Wedlake Bell LLP
Dan Burns	McguireWoods
Nigel Burton	Petrosaudi Oil Services
Anthony Carey	Mazars LLP
Louis Cooper	Crowe Clark Whitehill
Madeleine Cordes	Capita Registrars Ltd
Edward Craft	Wedlake Bell LLP
Kate Elsdon	PricewaterhouseCoopers LLP
Nicola Evans	Hogan Lovells International LLP
Clive Garston	Davies Arnold Cooper LLP
Nick Graves	Burges Salmon
Eugenia Jackson	F & C Asset Management plc
Colin Jones	UHY Hacker Young
Dalia Joseph	Oriel Securities Limited
Derek Marsh	China Food Company PLC
Georgina Marshall	Aviva Investors
James Parkes	CMS Cameron McKenna LLP
Nick Teunon	FTSE International Limited
Andrew Viner	BDO LLP
Melanie Wadsworth	Faegre & Benson LLP
Cliff Weight	MM & K Limited
Kate Jalbert	Quoted Companies Alliance
Tim Ward	Quoted Companies Alliance

APPENDIX B

THE QUOTED COMPANIES ALLIANCE (QCA)

A not-for-profit organisation funded by its membership, the QCA represents the interests of small and mid-cap quoted companies, their advisors and investors. It was founded in 1992, originally known as CISCO.

The QCA is governed by an elected Executive Committee, and undertakes its work through a number of highly focussed, multi-disciplinary committees and working groups of members who concentrate on specific areas of concern, in particular:

- taxation
- legislation affecting small and mid-cap quoted companies
- corporate governance
- employee share schemes
- trading, settlement and custody of shares
- structure and regulation of stock markets for small and mid-cap quoted companies
- political liaison – briefing and influencing Westminster and Whitehall, the City and Brussels
- accounting standards proposals from various standard-setters

The QCA is a founder member of European**Issuers**, which represents quoted companies in fourteen European countries.

QCA's Aims and Objectives

The QCA works for small and mid-cap quoted companies in the United Kingdom and Europe to promote and maintain vibrant, healthy and liquid capital markets. Its principal objectives are:

Lobbying the Government, Brussels and other regulators to reduce the costing and time consuming burden of regulation, which falls disproportionately on smaller quoted companies

Promoting the smaller quoted company sector and taking steps to increase investor interest and improve shareholder liquidity for companies in it.

Educating companies in the sector about best practice in areas such as corporate governance and investor relations.

Providing a forum for small and mid-cap quoted company directors to network and discuss solutions to topical issues with their peer group, sector professionals and influential City figures.

Small and mid-cap quoted companies' contribute considerably to the UK economy:

- There are approximately 2,000 small and mid-cap quoted companies
- They represent around 85% of all quoted companies in the UK
- They employ approximately 1 million people, representing around 4% of total private sector employment
- Every 5% growth in the small and mid-cap quoted company sector could reduce UK unemployment by a further 50,000
- They generate:
    - corporation tax payable of £560 million per annum
    - income tax paid of £3 billion per annum
    - social security paid (employers' NIC) of £3 billion per annum
    - employees' national insurance contribution paid of £2 billion per annum
    -

The tax figures <u>exclude</u> business rates, VAT and other indirect taxes.

For more information contact:
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