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?

We believe that some reassurance about 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.

This could be partially achieved by the company's chief risk reporting inter alia identifying the relevant sensitivities to the risks identified and perhaps indicating the extent of the variations permitted by the board and actions taken or to be taken when volatility is identified.

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 note the recent problems at Southern Cross and that the initial reporting to the market of acute problems made earlier this year and that the annual report noted these problems in the blandest and briefest possible terms. We quote from the risk report in full on the risks that relate to its well publicised problems:

- average weekly fees do not rise, at least in line with costs, putting profit margins under pressure;
- failure to meet bank covenants;

Whilst it may be too late for this company it is important that both investors and regulators remain vigilant and ensure that business reviews and other disclosures, including those to the market, provide a genuinely balanced view of companies' positions.

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 useful information to outside investors and other stakeholders and so does the profession a disservice. Whilst 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. We believe fuller disclosure is a way of demonstrating audit quality and so building investor confidence.

Moreover, the audit merely tests the position of the company at the balance sheet date; whilst the going concern statement provides for some forward looking thought, the audit process does not generally allow for intelligent 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, it is our belief that raising issues regarding the fair value approach in IFRS is largely irrelevant: 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 - which, for the record, we believe are largely fit for purpose following the post-crisis reforms.

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?

We refer to our answer to question 3. For the overwhelming majority of companies, disclosure to outsiders on how the assessments are reached is minimal at best. We would welcome companies shining some light on how their assessments are made.

Specifically in relation to question 7, we are concerned about how the directors of boards that do not meet more or less monthly and audit committees that only meet a couple of times a year are able to satisfy themselves about up to date liquidity and cashflow positions.

We get very little insight as outsiders in relation to question 8.

Our concern, certainly borne out anecdotally in relation to question 9, is that debates 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 steward of shareholders' assets.

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 instance we are told by the audit profession that the failed banks obtained clean audits shortly before they failed. This suggests either that the audits were flawed or more likely that the underlying philosophy to audit is framed incorrectly. 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 type 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?

The guidance itself is useful but does not itself solve some of the fundamental problems we have highlighted. 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. We believe that the guidance is helpful but would suggest that the points we make in 3 and 11 above about the need for some light being shed on the complex dynamics that lead the directors to make their statement is essential. We are not sure that necessarily clarifying the boundaries between the types of companies is helpful, 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 the company's course.

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

Our general concern, which is a difficult one to resolve, is to achieve better reporting on the lines we have attempted to describe, and to avoid meaningless boilerplate. This can best be achieved by companies being better rewarded for good reporting. This process has been started by the ICSA/Hermes Awards and similar initiatives but has to be extended to encouraging both boards and in particular shareholders to think in a longer term fashion, to encourage greater mutual understanding and thereby fewer unpleasant surprises that are punished severely by the market.