SHARMAN INQUIRY
Sharman Secretariat
c/o Financial Reporting Council
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CALL FOR EVIDENCE

Going concern and liquidity risks: Lessons for companies and auditors

In November 2009 the FRC provided guidance on addressing the exceptional risks to going concern and liquidity which were facing companies at the height of the credit crisis. This guidance met the immediate need for guidance on going concern assessments and disclosures associated with the production of annual and half-yearly financial statements. Although credit markets have since stabilised, going concern and liquidity risk continue to be critical corporate reporting and audit issues as well as part of a company's overall governance framework.

This inquiry is aimed at ensuring that the lessons of the recent past are captured, the FRC guidance is developed as necessary and best practice in dealing with a range of related issues is shared widely.

Evidence is invited by 30 June 2011. The Panel will welcome written submissions on any or all of the questions set out 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?

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?

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?

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?

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[1]. 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?

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[1] The disclosures in the financial statements which follow from the directors' conclusion on whether the company is a going concern identify three categories of company:

1. Those where the use of the going concern basis of accounting is appropriate and there are no material uncertainties related to events or conditions that may cast significant doubt about the ability of the company to continue as a going concern;
2. Those where the use of the going concern basis of accounting is appropriate but there are material uncertainties related to events or conditions that may cast significant doubt about the ability of the company to continue as a going concern; and
3. Those where the going concern basis is not appropriate.

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?

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?

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

Please note:

Evidence submitted will be published on the Panel of Inquiry's website, unless a witness requests that their evidence remains confidential.

Evidence submitted should be printed or typed and set out in numbered paragraphs, clearly indicating the author's name, address and status and whether the evidence is submitted on an individual or corporate basis. Additionally authors should note from what perspective(s) they are writing their evidence, both in terms of their current and past roles and the industry their experience relates to. If experience has been gained in more than one industry, any differences should be drawn out in the body of the evidence. Submissions by e-mail are preferred (as attachments in Word), with a signed, hard copy to follow.

Concise submissions of ten pages or fewer are preferred; longer submissions should include a single page summary. Witnesses who submit original written evidence may be invited to give oral evidence; summaries of such sessions will be agreed with participants but will not be published.

Evidence and enquiries should be addressed to:
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11 May 2011