Going Concern and Liquidity Risk: Lessons for companies and auditors

Submission by Peter Grant, CFO, SkyePharma PLC

This submission is provided based on my personal experience at SkyePharma and at other listed companies in the UK and the Netherlands.

Comments are given in selected areas using the references in the call for evidence dated 11 May 2011

Background

SkyePharma PLC is a leading speciality drug delivery company specialising in oral and inhalation technologies. Pharmaceutical development is inherently expensive and risky as the development cycle for new products is long and uncertain and the regulatory environment is complex and subject to change. The Group has significant short and long term debt obligations requiring regular debt servicing payments. The Board has established a continuous process for identifying, evaluating and managing the significant risks the Group faces, including its financing needs over the short and medium term.

[Not commented on items 1 to 4]

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….

At SkyePharma we use a comprehensive cash flow forecasting model based on detailed revenue and costs forecasts. The revenue forecasts are prepared following detailed senior management reviews on a monthly basis and indirect cost forecasts are based on detailed budgets and extrapolation of trends. The general aim is to project revenues and costs and, therefore, cash flows on a realistic but reasonably prudent basis. At least every half year, the base case forecasts are stress-tested with a downside model and upside opportunities are also assessed. The downside and upside cases take into account reasonably likely (but not central case) assumptions and provide a balance of the range and likelihood of possible outcomes. We also summarise the cash flow implications of potential, but unlikely, risks and opportunities not included in the downside and upside models. The base cash forecast is updated on a monthly basis and the summary reported to and reviewed by the Board.

These models are reviewed in detail at various levels of management, and, together with a report, the detailed half yearly model is reviewed by the Audit Committee, Board and Group Auditors before finalising interim and full year accounts. It is used to inform the level of disclosures to make in reports to shareholders.

The above modelling process was introduced in early 2007 and has proved to be a good predictor of likely cash flows, subject, as always, to the effects of binary events occurring. As such it has been quite effective in assessing the robustness and adequacy of the company's capital and its ability to continue financing and developing its business model.

6. What is different about the review of going concern when raising capital compared to the annual going concern assessment ….

In my personal experience, over the last 10 to 15 years, the general degree of prudence required by auditing firms when reviewing going concern for the purpose of supporting a Board in making a working capital statement when raising capital (or indeed issuing a Class 1 circular) has become much more onerous for companies. The procedures appear to be basically the same as for a normal annual accounting going concern assessment, but the degree of prudence expected by audit firms (and perhaps sponsors) is much greater. In my experience there now appears to be an expectation for a company to show it has adequate working capital to meet significant downside case needs without the ability to take account of the upside potential.

For a main market listed company with a small market capitalisation even quite small transactions are Class 1, and even those manifestly in the interests of the business (for example the disposal of a loss-making and cash-absorbing business) may require shareholders' consent and, therefore, a Class 1 Circular and a working capital statement. The adoption of a very prudent approach to the working capital needs may make it almost impossible for Directors to make the working capital statement and conclude the transaction (other than through the "distress situation" exemption, which can only be a very last resort). There should be more balanced guidance on working capital statements (and outside the scope of your enquiry) a rethink of in what circumstances such statements should be required. I would strongly recommend that working capital assessments for routine audit purposes, whilst being alert to downside risks for disclosures and the form of audit report, continue to consider the most likely base case for the purpose of assessing going concern.

7. Does the company assess future cash flows and liquidity on a regular basis throughout the year? …

As noted under the answer to (5) above, at SkyePharma we update future cash flows and liquidity forecasts every month and review this with the Board. The information prepared is similar to the annual and half-yearly review, except that it concentrates on the base case alone and doesn't have as much degree of review and additional reporting or formal assessment of upsides and downsides. Management and the Board are well aware of the need to keep forecasts under review and update the forecasts rapidly if matters arise which are likely to have significant effects on future cash flows.

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

As explained in the introductory background note above, SkyePharma's business cycle is more longer term than most businesses. This imposes a continuing obligation on our Directors to look out further than a typical going concern assessment. In some cases this may look out 5 years or more, depending on the debt maturity profile.

9. The current model of disclosure identifies three categories of company….

The current model is too prescriptive, as going concern is a matter of judgement on a continuous spectrum. The words required to be used by the auditors where there is an emphasis of matter say that "there are material uncertainties related to ….. that may cast significant doubt about the ability of the company to continue as a going concern". This wording may be interpreted by many readers

of accounts as meaning that those uncertainties are not only material but quite likely, and which mean that the company may not continue as a going concern. That such a note could be read in such a way presents a misleading position. In my experience there are occasions where it is absolutely appropriate to disclose significant matters which do not have an impact on the immediate going concern status of a company, but this should not give rise to wording which implies that there is a going concern issue within the next 12 months. In these circumstances the auditors have no discretion to interpret the overall situation and alert shareholders to material uncertainties without using the prescriptive wording. In marginal situations this may lead to auditors not alerting shareholders. In other situations the prescriptive wording could be interpreted as meaning that a situation is worse than it is and lead to adverse credit consequences for a company. In my opinion the guidelines should be expanded to recognise these situations and distinguish more clearly between risks requiring disclosures and risks affecting the assessment of going concern in the following 12 months.

[Not commented on items 10 and 11]

Feedback on the Guidance for Directors …

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? …

I feel strongly that the present guidance for auditors is far too prescriptive on the words to be used. Any attempt to require Directors to use more standardised wording would be a backwards step. There are a number of possible consequences of such a move:

- It is likely to lead to more contention between Auditors and Directors as to which category a company fell into;
- It is likely to mislead users of accounts by being too negative, unclear or insufficiently detailed and result in credit issues for Companies;
- It could lead users of accounts into regarding going concern wording as "standard" and lead to less awareness of issues.

There aren't clear boundaries between the three types of company as there aren't actually three types of companies. There is a continuous spectrum and the emphasis should be on good and proper disclosure of liquidity concerns and potential risks. As indicated above, I believe the categories should be expanded and more discretion permitted in wording adopted by auditors rather than restricting the wording to be used by the Directors.

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

(a) Consideration should be given to clearer guidance on the period covered by a going concern statement. The rule of thumb is 12 months, with practice looking out 18 months and possibly longer. It would be helpful to users of accounts if there was a disclosure that the relevant period is 12 months. There should, nevertheless, be guidance to refer to potentially key events that may happen in the future in a longer time frame that may have a material effect on cash flows in that longer time frame. However, this should not necessarily drive an emphasis of matter if there is appropriate disclosure in the annual report. As an example of additional disclosures of this nature, in the SkyePharma 2010 report and accounts we provided in Note 2:

(i) the usual disclosures about going concern and uncertainties in the next 12 months, which were referenced in the Auditors' emphasis of matter statement, and

(ii) an explanatory note about longer-term bond put options, prefaced "Whilst not a material uncertainty affecting going concern…", which was not referenced in the Auditors' report as it fell outside the going concern period.

(b) (Probably outside the scope of your enquiry, but worth consideration by the government). Many years ago, and not related to SkyePharma, I was a Director of a listed company in the Netherlands which had substantial indebtedness. In discussions with banks about rescheduling some of the debt one of the Dutch banks informed me, in confidence, that even if the facility agreement allowed them to call the debt for payment, they were constrained from doing so by having to have a dialogue with and justify why they would do so to the Dutch central bank. The impression I gained was that this acted as a "brake" on bankers "pulling the plug" on a business due to a breach of covenant, and that the bank felt it had to act reasonably and try to support an otherwise viable business. I have never been able to ascertain if this procedure exists (or existed) but, whilst it may make it a little more difficult to obtain bank facilities in the first place, it should be considered to protect businesses trying, in good faith, to manage their way through difficult situations.

I remain available for further comments if any of the above needs additional explanation.

Peter Grant

Chief Financial Officer
SkyePharma PLC
46-48 Grosvenor Gardens
London SW1W 0EB

30 June 2011