ERNST & YOUNG

Ernst & Young LLP
1 More London Place
London SE1 2AF
Tel: 020 7951 2000
Fax: 020 7951 1345
www.ey.com/uk

The Sharman Secretariat
c/o Financial Reporting Council
Aldwych House
71-91 Aldwych
London WC2B 4HN

6 July 2011

Ref: EY2011

Direct line: 0207 951 3050

Email: roverend@uk.ey.com

By post and email: sharman.secretariat@frc.org.uk

Dear Mr Grabowski

Sharman inquiry – call for evidence

1. Ernst & Young LLP welcomes the opportunity to respond to the *Call for evidence - going concern and liquidity risks: lessons for companies and auditors, May 2011* ("the Paper"), issued by the Sharman Secretariat.

2. Our views in this letter reflect our experience and knowledge gained from providing audit and non-audit services, to different types and sizes of listed and unlisted company operating in various sectors. Our response is also influenced by the views we shared with the FRC on its earlier study into going concern and liquidity risk, and its proposed guidance which was issued for comment at the height of the financial crisis.[1]

3. The FRC's guidance, together with the requirements of UK company law, accounting standards and listing rules, provide a framework for assessing and reporting going concern and liquidity risk in the UK. In particular, the principles-based format of the FRC's requirements enables companies to assess and report on their going concern status in a proportionate way, relative to their particular circumstances.

4. This framework has been put to the test over the last two years. Accordingly, it should be reviewed so that lessons can be learned and opportunities sought, to refine and enhance its effectiveness if necessary. In this regard, consideration should also be given to the way the framework is used, and whether changes are required in terms of educating and supporting both preparers and users. Further, we do not believe that this issue should be considered in isolation from other subjects including effective corporate stewardship, corporate governance and corporate reporting, or in isolation from other global standard setters.

---

[1] 'Proposals to revise the guidance for directors of listed companies, FRC, September 2008'. 'Going concern and liquidity risk disclosures', FRC, November 2008. 'An update for directors of listed companies: going concern and liquidity risk', FRC, November 2008.

INVESTOR IN PEOPLE

The UK firm Ernst & Young LLP is a limited liability partnership registered in England and Wales with registered number OC300001 and is a member firm of Ernst & Young Global Limited. A list of members' names is available for inspection at 1 More London Place, London SE1 2AF, the firm's principal place of business and registered office.

Overall comments

5. The Paper focuses on how directors form going concern statements, and what auditors do to assess them. However, there is an important distinction to be made between the binary decision on whether it is appropriate to prepare the accounts on a going concern basis, and wider issues as to disclosures which provide users with high quality comprehensible information about the underlying financial strength and viability of a company. This is highly relevant to the Paper, so we recommend that further investigations are conducted, to see how this distinction can be clarified and understood by users and the wider public. This work can help to establish a point of reference, against which preparers' and users' preconceptions can be assessed, to gauge the expected/intended content and purpose of going concern statements and, just as importantly, whether the current level of audit assurance provided on going concern statements meets users' needs.

6. We encourage the Secretariat to look closely at these preconceptions, because the meaning placed on going concern statements will have a bearing on how they are prepared and used, and whether they are considered fit for purpose. Likewise, the respondents' expectations of the company report and accounts, e.g., as a record of historical stewardship or a forward looking report, could also influence the level of importance respondents place on the going concern statement, so these expectations should also be looked at more closely.

7. By investigating these issues further, it should be possible to see if there is an expectations gap between the commercial objectives of preparers and the needs of users (e.g., who might assume wrongly that a going concern statement guarantees a company's financial strength) with a view to identifying initiatives to bridge the gap. Existing measures (e.g., IFRS, going concern guidance for directors, and guidance in the Reporting Statement: Operating and Financial Review) help in this regard, although there may be scope to seek further improvements in the Guidance for Directors. However, before any initiatives are launched to amend disclosure requirements, consideration should be given to the potential effects of these changes on the competitiveness of UK-based companies.

8. Examples of initiatives relevant to going concern, which could also help to enhance financial statements, might include the following:

   a. De-clutter the report and accounts, to make it shorter and simpler to read, so users can find and cross-refer information of most relevance to going concern (e.g., information related to a going concern can be found in at least 20 different places in a set of financial statements, these could be signposted or indexed to make them more accessible).

   b. Highlight, and list separately, the principal risks and uncertainties which might affect the going concern status of a company, with clear explanations of how they are being mitigated by the company.

   c. Provide a means to sign-post or highlight specific parts of the accounts which might have a particular bearing on a company's prospects for the future, to help users navigate to the information they need for investment decisions and other purposes.

d. Provide further guidance on the use of the Companies Act 2006 safe harbour provisions, so directors understand the extent to which the relief can apply to these statements, and consider doing the same for auditors if they are required to provide assurance on forward-looking statements.

e. Publish guidance for the users of accounts, and seek opportunities to help educate users on what to look for when assessing a going concern statement.

9. In writing this letter we are mindful of the House of Lord's inquiry into auditing, and its views on going concern, which has influenced this Paper. In this regard, we believe there is a need to inform the public about the meaning of going concern, within the context of accounting and auditing standards.

10. In particular, there is a general misconception which needs to be addressed, namely that a going concern statement guarantees a company's future performance. Also, a better disclosure of risk (as referenced in our responses to the Paper's questions) together with information on the financing model, may be more informative and helpful to the public in its understanding of the future prospects of a company. Finally, in respect of financial institutions, stakeholders need clearer information on how going concern assessments are made in the context of prudential regulation, and how related issues are resolved.

Concluding remarks

We recognise the importance of this Paper, following earlier public inquiries in the aftermath of the financial crisis. That said, we believe the underlying detail which supports going concern and liquidity risk disclosure in the UK, and the related guidance for directors, are broadly fit for purpose. Therefore, the focus of attention for this Paper should, in our view, be centred on matters related to the effectiveness of company stewardship, as a means to help users of financial statements to find and make sense of relevant and proportionate company information, insofar as it relates to going concern in the broader context of a company's performance.

To this end we believe there is scope for disclosures to be made in a more accessible way, by repositioning and deemphasising less relevant information in corporate reports, thereby avoiding the risk of obscuring more relevant information from users. Both topics are currently under close examination by the FRC, and we will continue to engage with the FRC on these matters through consultation responses and ongoing dialogue.

We are grateful to the Secretariat for issuing this Paper, and we hope you have found our comments helpful. If you would like to discuss any of the points we have raised, please contact me on 0207 951 3050. We wish you every success with the rest of the process, and for the avoidance of any doubt this is not a confidential reply.

Yours sincerely

Robert Overend
Partner, UK Audit Compliance Principal

Appendix

Q1 Transparency of going concern and liquidity risk: 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 combination of information from a set of accounts, required to enable users to evaluate a company's going concern and liquidity risk, will vary depending on a company's financial manoeuvrability (i.e., the types of risk it is likely to encounter, and the level of its cash reserves and/or loan facilities available to mitigate these risks). Similarly, the strength of a company's trading activity and the public's perception of it might influence the tone of its going concern statement. For example, its language may become more circumspect if trading conditions are expected to worsen. Conversely, if trading is already known to be poor, a company may be more open to avoid creating suspicion in the markets that it may have something to hide.

Therefore, the going concern status of a company is not a fixed constant. It is a variable measure, made in reference to the unique circumstances of each company at a moment in time, to determine whether the accounts can be prepared on a going concern basis. Accordingly, there is no definitive combination of information which can help to inform every going concern assessment, and these assessments are not meant to define the financial strength of a company, although the two are often used interchangeably.

In terms of financial statements, the different disclosures may have a greater or lesser relevance to determining the going concern status of a particular company (e.g., cash/debt position, liquidity risks, ongoing commitments, future outflows and the impact of treasury operations and financial instruments). We estimate that there are at least 20 different places in a typical set of financial statements that could relate to a going concern statement:

- s417/RS, requirements regarding the balanced analysis of a company's position, cash flows etc. RS paragraphs 68-70.
- Treasury policies, RS (65) and DTR, IFRS 7
- Liquidity RS (71-74) Liquidity risk.
- Capital management, RS (63), IAS 1. 134, 135.
- Going concern code, IAS 1.23.
- Audit report - if it contains an emphasis of matter or qualification on a going concern.
- Cash-flow statement.
- IAS1 Judgements and Estimates, to the extent that any of these disclosures impact on potential cash-flows e.g., impairment.
- IFRS 8.34, information about dependency on major customers.
- IAS 1, Dividends proposed to be paid next year - indicative of liquidity strength.

- IAS 36, Impairment disclosures and specifically key assumptions used in VIU calculations and sensitivity analysis.
- IFRS 7.36, Trade receivables past due not impaired.
- IFRS 7, Cash and deposits, any restrictions on cash (escrow) etc should be disclosed.
- Redeemable preference, any potential triggering events outside of a company's control.
- IAS 17, Lease/HP obligations by maturity, finance and operating lease commitments.
- Provisions IAS37, Uncertainties in relation to cash outflows for provisions.
- IFRS 7, Liquidity risk disclosures for financial instruments.
- IFRS 7 / IAS 39, Cash-flow hedges and the extent to which future cash flows are hedged.
- IAS 10, IAS 16, IAS 37, Disclosures on PBSE's, capital commitments and contingent liabilities that might impact cash flows.
- IAS 19.120, Amount expected to be paid into plan and general funding issues regarding the plan.

If the information listed above is sign-posted or indexed in some way, it might help the user who is interested in the going concern status of a company, to access information relevant for that purpose more effectively and efficiently.

Q2 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 ongoing concern and liquidity risk in the annual and interim financial statements?

Listed entities have obligations to disclose price-relevant information as soon as possible. Banks and financial institutions have also made additional disclosures (e.g., capital reserves and resolution arrangements) during the financial crisis.

As well as these ongoing disclosure requirements, companies will also make disclosures if they issue a circular or prospectus. In these situations companies are usually looking to refinance their businesses (e.g., through a rights issue or disposal) and the contents of these disclosures focus on working capital requirements.

By their nature these disclosures are usually timely and forward looking, and require more detailed information compared with the input expected of an annual going concern statement. The circular or prospectus will be regarded as a supplement to, rather than a replacement of other disclosures on risks and uncertainties covered in reports such as the business review.

Q3 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?

A potential barrier can be created by hesitancy and risk aversion on the part of directors and their legal advisers, if they believe that a full disclosure might exacerbate and/or create issues in the market which had not previously existed (e.g., creating a self-fulfilling prophecy). Further guidance on making risk disclosures, and more information on the use of the Companies Act 2006 safe harbour provisions[2] - so directors understand the extent to which the relief can apply to these statements - might help to reduce this barrier. Similarly, the publication of case studies and best practice examples might help to encourage directors to make disclosures which are fuller and more balanced than might otherwise be the case.

Although we agree with the principle of making full disclosures, in some situations limiting information might enable users to comprehend matters more effectively. For example, disclosing principal risks and uncertainties, rather than listing all risks and uncertainties, might enable users to get a better understanding of a company's main risk profile, in a quicker and more effective way.

Q4 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?

We believe IFRS, when properly complied with, is effective for the purposes of measurement, recognition and disclosure. However, it has been recognised by the FRC and other bodies that financial statements can sometimes become cluttered, and the importance of some disclosures may be obscured in the volume of information.

Within the Financial Services market, robustness of capital is a relatively well understood and regulated measure. Outside the Financial Services market, the concept is less clear and could vary from industry to industry, taking into account factors such as the natural business cycle.

Q5 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?

Processes are undertaken by companies in the context of the type and size of their businesses, and the sectors in which they trade. That said, as a general observation, directors tend to consider all potential risks facing the business. Alongside this, they

---

[2] Section 463, Companies Act 2006, is designed to give comfort to directors that they cannot be sued for negligence, for example by making forward-looking statements.

generally review the strength of the balance sheet, and in particular consider the extent to which it is leveraged and how much headroom the company has in terms of its bank covenants, should any of these risks take effect. In these circumstances they will review the key assumptions in the forecasts for trading and cash flows.

The formal annual and half yearly assessment of going concern tends to build on other processes already in place, including the annual budgetary cycle and re-forecasting process, longer term planning cycles, risk reviews, and treasury processes. The depth of the review varies in line with the perceived risk to the company's ability to carry on as a going concern and the level of its headroom.

Q6 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?

The two reviews mentioned in the question serve different purposes, so we do not believe that aspects of the former would necessarily fit in well with the latter, and vice versa. The main distinction between the two is that the capital raising review will focus principally on the working capital requirements and cash flow of a business. This will be a more detailed report and set of disclosures, especially in circumstances where a new business is to be launched or formed through an IPO or corporate transaction, whereas the annual accounts serve a different purpose, including the provision of an historical record of stewardship.

For a working capital statement directors and their advisers have to be reasonably certain they are going to trade through for the period. The directors do detailed work and they look for long reports from auditors to support their view; they also ensure they have the facilities they need in place when they sign off (not necessarily the case for a normal going concern assessment); and they may agree to sign up to more facilities than they might think they need to cover "worst case" flexed scenarios. All of this costs the company money to buy the higher assurance that goes with a working capital statement. The question is should you always have that higher assurance at that greater cost. We do not believe that these procedures (and the associated costs) are proportionate to the routine consideration of going concern.

Q7 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?

Companies assess future cash flows and liquidity at regular intervals. Some will monitor and manage the cash cycle on a daily basis, others weekly or monthly. The level of focus and detail will also vary, in line with the perceived liquidity risk. When there are peaks and troughs in cash reserves, board directors tend to get more focused on cash flows, and the level of detail increases. Further, the focus on short-term considerations will increase as the liquidity risk increases.

Q8 To what extent and how do directors assess the viability of a company over the course of its natural business cycle?

It is unclear what "natural business cycle" means, or whether there would be a shared understanding of the concept among preparers and users of accounts. However, directors regularly assess the strategy of their company (for example in the annual budgeting process) and will consider options to revise the strategic direction of the company, including the closure of operations or business lines as circumstances dictate. The frequency of this strategic planning may increase as the level of liquidity risk increases.

Q9 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?

Our views on this subject were shared with the FRC when it reviewed this model in 2008. At that time four categories of company existed and we supported the FRC's proposal to reduce that number to three - the current situation. Our opinion has not changed, although there could be merit in providing additional guidance to promote the quality (i.e., clarity and completeness) of disclosures, with examples of how statements have been written in relation to the different categories in the model.

Similarly, we believe it is important for companies, regulators and other interested parties to help educate users on the different meanings and implications of an auditor's 'emphasis of matter' and 'qualification'. In particular, users must read an emphasis of matter in its proper context, so that they do not make the wrong conclusion about the financial viability of a company. Also, it would be beneficial for all concerned if the role and interrelationship between regulators and auditors was more clearly understood, especially in the financial services industry, in circumstances where prudential regulators are notified by auditors when systemically significant entities get into difficulty. Depending on the circumstances, this can result in a regulatory intervention pre-empting the need for the auditor to qualify its report or fill it with matters of emphasis.

Q10 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 current economic climate, both macro and micro and including high-profile corporate failures globally, has focused stakeholder attention on the risk of financing withdrawal and illiquidity. This is one of the issues which have heightened focus on the assessment of going concern. As a consequence, closer attention has been drawn to the disclosure of funding lines, their maturity dates and interest arrangements, which has brought IFRS 7 under the spotlight.

During the banking crisis regulators and auditors shared information on entities which were under a high level of duress. In some circumstances regulators intervened, as indicated in the response to Q9.

Q11 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 ongoing 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?

ISA (UK and Ireland 570, Going Concern) lays down the procedures that an auditor is required to perform when it assesses the company's ability to carry on as a going concern. Auditors also make use of the Guidance for Directors on Going Concern and Liquidity Risk when discussing with management their assessment of the company's position. The quality of the audit work will also be influenced by the quality of management's assessment and supporting documentation. The level of work performed, including the use of any experts, and reports to the Audit Committee will respond to the risks identified. Different industry sectors do not necessarily lead to different procedures being performed, although factors specific to an industry sector may have a bearing on the identification of risk.

The key to a successful audit of the going concern assessment is ensuring that an appropriate level of professional scepticism is shown relevant to the circumstances, and that the right team members, including appropriate experts, consider the issue at the appropriate time.

Q12 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 do not believe that amendments are required to the guidance, which is evidenced by the way in which companies have embraced its principles. This is because the guidance reflects the needs of stakeholders identified in earlier FRC consultations, and in our experience it serves its purpose well.

In particular, and for the reasons outlined in our response to this Paper, going concern disclosures will vary to reflect the particular circumstances of each company. The guidance and categories used in the current model of disclosure accommodates this effectively.

That said, there may be scope to supplement the guidance with examples of going concern statements, to help promote best practice in terms of the emphasis and tonality used in the reporting language. The FRRP's ongoing review of financial statements could perhaps identify best practice going concern statements.

We also believe there is an opportunity for new initiatives to help educate policymakers and opinion formers, on the meaning of going concern and the role of auditors and regulators in this regard. In particular, we believe there is a need to improve the general level of understanding in terms of how auditors and regulators interact in regards to the going concern of banks and other financial institutions.

Q13 Are there any other views that you would like the Panel of Inquiry to take into account?

Recognising that this Paper is a call for evidence, and it is too early to say what proposals might develop from this initiative, we would nevertheless like to emphasise the importance of preceding any policy developments with an impact assessment. The costs and benefits of any proposed changes, including the potential effect on the UK's competitiveness, needs to be considered alongside other regulatory developments which might be planned at the same time.