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Dear Sirs

Implementing the Recommendations of the Sharman Panel
Revised Guidance on Going Concern and revised International Standards on Auditing (UK and Ireland)

We appreciate the opportunity to respond to this consultation by the Financial Reporting Council (FRC) on implementing the recommendations of the Panel of Inquiry led by Lord Sharman. We welcomed the original initiative of the FRC to set up the Panel to identify, in the light of the credit crisis, lessons for companies and auditors addressing going concern and liquidity risks. We responded in June 2011 to the Panel's initial call for evidence and in December 2011 to the consultation on the Panel's preliminary report, and are ready to contribute further views and insights from within our firm to assist the FRC.

Our specific responses to each of the questions in the consultation paper are set out in the accompanying Annex. In this letter we highlight our views on what we consider to be some of the more important issues raised in the document.

Overall reactions to the proposals

We strongly support the FRC's desire to see enhanced narrative reporting by companies on their business models, risks and financing – and a stronger link between business planning and the assessment of going concern. We also continue to support an approach that suits the UK's corporate governance model which accords a significant role for audit committees.

However, we consider that the proposed guidance, incorporating a new "stewardship" assessment of going concern to sit alongside the financial reporting assessment, is over-complex and impractical to implement for companies of all sizes. It also risks sowing confusion in the minds of users of financial statements. We propose below an alternative approach that we believe would achieve the FRC's objectives more simply while preserving

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and maintaining confidence in the basic mechanics of the current going concern assessment by companies and auditors.

Enhanced narrative reporting on risk, financing and going concern

We continue to strongly support initiatives that focus on enhanced narrative reporting by companies on - and greater linkage between - their business model, risks and financing.

This is consistent with our view, noted in our previous evidence to the Panel and in other recent responses to the FRC (for example on *'Effective Company Stewardship'*) that the whole corporate reporting model should be looked at afresh. There is a need for a more coherent picture of a company's strategy, business model, appetite for risk, key areas of risk, funding, and performance to be presented in annual reports (where narrative, financial and non-financial information are brought together).

There are a number of institutional efforts aimed at improving risk reporting, both generally and for specific sectors such as banks (for example through the Enhanced Disclosure Task Force). We would like to see the FRC help communicate this broader vision and to play a full part in moving the broader corporate reporting model in this direction. As noted in our recent response to the FRC's Draft Plan and Budget for 2013-14, we believe an explanation of the overall corporate reporting model to which the FRC aspires would help stakeholders to better understand where the FRC's individual pronouncements fit in. By introducing elements of the model piecemeal in advance of preparing the ground for the broader enhanced model, there is a risk that the objectives of the Sharman proposals will not be understood and the potential benefits not achieved.

New concepts and terminology – an over-complicated framework

The consultation document introduces many new concepts and terminology (some of which were not trailed in the previous Sharman consultations) that companies and auditors are not presently used to dealing with in their current assessments of going concern. Examples of this are:

- The identification of separate "stewardship" and "financial reporting" purposes of going concern reporting – having two purposes or concepts of going concern side by side may confuse readers and could undermine confidence in, and understanding of, the current model;
- New terms applied in the assessment of the stewardship concept of going concern, such as "high level of confidence" – this terminology is not currently used and is not adequately defined in the proposed guidance;
- Solvency and liquidity considerations, and related stress tests for each – for most businesses, their going concern focus has been primarily on liquidity;
- The need to reflect both business and economic cycles – these are inherently difficult to define and will be difficult to implement; and
- Actions identified as being within or outside the normal course of business – the examples used in the proposed guidance provide a stark comparison, but in most

cases the reality will be in the middle ground and the categorisation will be highly judgmental.

Taken together, these new parameters represent a great deal for company management, directors, audit committees and auditors to digest. While we are fully sympathetic to the FRC's intentions in encouraging companies to more closely integrate the assessment of going concern into regular business planning, we question whether introducing all these new concepts, in the absence of the broader corporate reporting vision within which they sit, will deliver the intended benefits and behavioural change that the FRC seeks.

In particular, we consider that differentiating "stewardship" and "financial reporting" purposes of going concern at best complicates the subject and, at worst, will result in unintended consequences. The stewardship purpose, as drafted in the guidance, is almost completely open-ended and indeterminate. It is not possible for companies to have a complete and reliable view of the future. A large number of companies may therefore believe they are unable to achieve the hurdle in the proposed guidance of a high level of confidence - and hence may "fail" the stewardship test while "passing" the financial reporting test. The proposed stewardship concept may thus not be practicable to implement to the level of confidence implied in the guidance.

We support efforts to encourage companies to provide more discussion around their view of the future and to stimulate more dialogue with investors. But we are concerned that the approach proposed will confuse investors and risks undermining confidence in, and understanding of, the current financial reporting approach to going concern. It could also inadvertently widen the expectation gap by giving the impression that management or the auditors can provide longer term guarantees about the future. For the reasons outlined above, we do not believe that introducing a separate stewardship test or hurdle is relevant or appropriate.

An alternative approach

We believe the objectives of the Sharman Panel could be better served by: firstly, leaving the current financial reporting assessment of going concern broadly as it is; and, secondly, using a different approach and terminology for the stewardship aspect so that it is not confused with the conventionally understood financial reporting meaning of going concern. The stewardship purpose could in our view be more simply achieved by requiring the directors to explain the needs for and sources of funding for the company, the risk factors attached to those funding sources and to the sustainability of the business model (which should already be a feature of good company narrative reports), and the key related assumptions that they have made in assessing going concern in preparing the financial statements.

The auditors could then confirm that the key assumptions disclosed are those that the directors considered in making their going concern assessment and that, based on their evaluation of those assumptions, the auditors have no reason to believe that they are not a reasonable basis for the directors' going concern assessment. We believe this approach, by focusing on the disclosure of the key supporting assumptions that have been used, would be preferable to the proposed statement by the auditors as to whether they have "anything to add or draw attention to" in relation to the disclosures made by the directors about the going concern assessment and its outcome.

Appropriate criteria would need to be drawn up in order to assist companies in making such disclosures, with complementary guidance for auditors. At the same time, there would need to be a clear understanding on the part of all stakeholders (directors, auditors, users and regulators) that such disclosures can never be complete in explaining every conceivable risk on the horizon – and that the directors give reasonable disclosures based on the knowledge available at the time. Hindsight should not be used to judge in a simplistic or undiscriminating way disclosures made previously in good faith.

This would give investors more helpful information to enable them to assess the strategy and risk tolerance of management and to draw their own conclusions, while avoiding creating a new, highly judgmental and potentially open-ended stewardship test of going concern. It would help stimulate a dialogue between companies and their investors about the sources of funding and the risks around them.

Implementation date

Should the FRC continue to pursue the approach in the draft guidance, we consider that the proposed implementation date for the revised guidance (years beginning 1 October 2012) is challenging, particularly in view of the fact that the guidance features, as outlined above, many new aspects. This is particularly the case for those companies with 30 September 2013 year-ends which would have only a very limited time to prepare following the publication of final guidance. We therefore suggest that the implementation date be put back, at a minimum, to apply for financial years beginning on or after 1 January 2013.

Consistency with international developments

A recommendation of the Panel was to clarify the purposes of the going concern assessment if possible in line with international consensus. A number of standard setting and regulatory bodies are currently looking at the financial reporting responsibilities and definitions of going concern, and at the related content and usefulness of the auditor's report. For example, the International Accounting Standards Board (IASB) and the International Auditing and Assurance Standards Board (IAASB) are each undertaking projects, covering aspects of going concern reporting. Since the standards used in connection with the financial reporting and auditing of many of the world's listed companies are now set principally at international level, we consider that different ideas on how companies and auditors report on going concern would be best discussed in an international forum.

The FRC should certainly propose ideas and continue to take a leading role in the international debate, but we would be concerned if the FRC's proposals resulted in UK reporting and audit standards diverging from international standards. We question whether, in introducing these and other reporting changes now, the FRC is requiring companies and auditors to adapt to new requirements with the possibility of having to make further changes once an international consensus emerges.

Proposed guidance for banks

The Sharman Panel of Inquiry was established largely in response to the going concern difficulties experienced by banks at the height of the financial crisis in 2007-08. The proposed guidance states that liquidity support from central banks may be a normal funding source for banks and reliance on such support does not necessarily mean that a bank is not a going concern or that material uncertainties should be disclosed or that an emphasis of matter paragraph should be included in the auditor's report.

While the legitimate intention of the FRC and the UK regulatory authorities is, through this guidance, to preserve financial stability, we believe that greater consideration needs to be given to the context of the overall corporate reporting and disclosure regime. As we explain further in our response to Question 11, non-disclosure of substantial support from Bank of England facilities needs to be considered also in relation to other disclosures required by accounting standards in order to give a true and fair view and to other disclosure obligations of directors. Without full consideration of the broader disclosure regime, it seems unreasonable to expect the directors or the auditors to conclude as a generality that such support will always be regarded as being in the normal course of business and hence not disclosable. The consequences of non-disclosure need to be viewed in the broader context and not simply in relation to the assessment and disclosure of going concern.

We would be delighted to discuss our views further with you. If you have any questions in the meantime regarding this letter, please contact Pauline Wallace (0207 804 1293), Andrew Ratcliffe (0207 212 4685) or Graham Gilmour (0207 804 2297).

Yours sincerely

PricewaterhouseCoopers LLP

ANNEX 1

Detailed responses to Questions in the Consultation Paper

Question 1: Do you agree that the Guidance appropriately provide the clarification recommended by the Panel as to the purposes of the going concern assessment and reporting and is appropriate? If not, why not, and what changes should be made to the Guidance?

- We believe that drawing a distinction between "stewardship" and "financial reporting" purposes of going concern at best complicates the subject and at worst could result in unintended consequences and could widen the expectation gap.
- Our experience, as articulated in our response to the Panel's original call for evidence, is that the basic mechanics of the current going concern assessment by companies and auditors are relatively well understood by those applying them. We are concerned that introducing a similar but different "stewardship" going concern concept alongside the existing financial reporting concept will undermine this understanding and cause confusion and uncertainty, particularly for users of corporate reports.
- We would suggest that, at a minimum, a different term be used for the stewardship purpose, such that it is not confused with the conventionally understood financial reporting meaning of going concern.
- Moreover, the stewardship purpose, as drafted in the guidance, is almost completely open-ended and indeterminate. It is not possible for companies to have a complete and reliable view of the future. The proposed stewardship concept may not be practicable to implement to the level of confidence implied in the guidance. We do not believe that introducing a separate stewardship test or hurdle is relevant or appropriate.
- If the aim is to improve companies' narrative reporting and create a better linkage between strategic and business planning and the financing requirements of the business, we consider this could have been achieved more simply and without proposing new concepts and tests which need to be "reconciled" with the financial reporting assessment of going concern.

Question 2: Do you agree with the description in the Guidance of when a Company should be judged to be a going concern? Do you agree in particular that this should take full account of all actions (whether within or outside the normal course of business) that the board would consider taking and that would be available to it; and that, if the underlying risks were to crystallise, there should be a high level of confidence that these actions would be effective in addressing them? Is the term 'a high level of confidence' sufficiently understandable? If not, why not, and how should the description or term be modified?

- We do not believe that introducing a separate "stewardship" test for going concern is necessary. As explained above, it could undermine the existing financial reporting concept of going concern and could result in confusion for readers of corporate reports.
- The hurdle of "high level of confidence" is not defined and is inherently judgmental and subjective. The terminology is not used in the current going concern literature.
- We believe the objectives of the Sharman Panel would be better served by requiring the directors to explain the needs for and sources of funding for the company, the risk factors attached to those finding sources and to the sustainability of the business model (which should already be a feature of good company narrative reports), and the key related assumptions that they have made in assessing going concern in preparing the financial statements. This could be coupled with better linkage with the existing disclosure of risk factors in the annual report. This would give investors more helpful information to enable them to assess the strategy and risk tolerance of management and enable them to draw their own conclusions, while avoiding creating a new, highly judgmental and potentially open-ended stewardship test of going concern.

Question 3: Do you agree with the approach the Guidance takes to the implications and nature of actions within or outside the normal course of business? Do you consider that the Guidance explains their nature sufficiently clearly? If not, why not and what changes should be made to the Guidance?

- We do not understand the purpose of the distinction in the guidance between actions within and outside the normal course of business. The terminology is introduced and used in the table examples in Section 2, paragraph 14 of the Guidance, but the distinction is simplistic – what is "normal" and what is not normal will be a matter of judgment in the circumstances. Moreover, the distinction has little bearing on the ultimate judgment as to whether the directors have a high level of confidence that mitigating factors are available to the board (under the "stewardship" purpose) or that the company will be able to continue as a going concern for the foreseeable future (under the "financial reporting" purpose).

Question 4: Do you agree with the approach taken to interpreting the foreseeable future and is this sufficiently clear in the Guidance? If not, why not and how should the Guidance be changed?

- While we agree that companies should consider both solvency and liquidity aspects in their assessments, most companies do not currently evaluate going concern from these two perspectives. For most companies, liquidity is, and is likely to remain, the more critical component.
- We believe there should be flexibility in how the Guidance is applied. Companies do not have identical circumstances and business models and therefore any final guidance should indicate that the weight given to the two aspects and the detailed specification of the related stress tests may differ.

Question 5: Do you agree that the use of the term 'going concern' in the phrase 'going concern basis of accounting' is sufficiently clearly distinguished in the Guidance from its use in the Code requirement for a statement that the company '<u>is</u> a going concern' and from its use in the accounting and auditing standards in the context of material uncertainties about the company's 'ability to continue as a going concern? Is it clear from the Guidance that the statement the directors are required to make under the Code (that the Company is a going concern) should reflect the board's judgement and is not intended to be absolute? If not, why not and what changes should be made to the Guidance or the Code requirement?

- As noted in our responses to Questions 1 and 2, we consider it unhelpful and potentially counter-productive to introduce new definitions or concepts of going concern. Internationally, there is already a patchwork of definitions of going concern used in the financial reporting context, and it will not serve to simplify matters if an additional (longer-horizon) stewardship definition or test is added.

Question 6: Do you agree that the judgemental approach in the Guidance to determining when there are material uncertainties to be disclosed is the appropriate interpretation of the relevant accounting standards? Do you agree that the factors and circumstances highlighted respectively in paragraphs 2.30 and 2.31 are appropriate? If not, why not and what changes should be made to the Guidance?

- We do not agree with the inference in these proposals (and echoed in recent speeches by FRC officials) that, as a result of introducing the revised Guidance, this may result in more material uncertainties being disclosed by management. The underlying definitions of material uncertainty as used in the accounting and auditing standards have not changed, so to suggest that more uncertainties will now be disclosed risks causing confusion in the minds of management, directors and auditors.

Question 7: Do you agree that the interpretations adopted in the Guidance in implementing Recommendation 2(b) are consistent with FRS 18 and ISA (UK and Ireland) 570? If not, why not and what changes should be made to the Guidance or those standards.

- We agree with the Panel's recommendation that the FRC seek to develop a common international understanding on the use of the term going concern. The FRC should propose ideas and continue to take a leading role in the international debate. In the meantime, we believe UK reporting and auditing standards should remain consistent with international norms.

Question 8: Do you agree that Section 2 of the Guidance appropriately implements Recommendation 3? Do you agree with the approach to stress tests and the application of prudence in conducting them? Do you agree with the approach to identifying significant solvency and liquidity risks? Do you agree

with the description of solvency and liquidity risks? If not, why not and what changes should be made to the Guidance?

- Our experience is that the majority of companies currently take a reasonable and considered approach to stress testing in the light of their specific circumstances.
- Companies do not have identical circumstances and business models and therefore any final guidance should indicate that the weight given to the two aspects of liquidity and solvency and the detailed specification of the related stress tests may differ.
- The draft Guidance also comes across as relatively prescriptive (for example, the frequent use of "should"). Hence for both these reasons we would advocate greater flexibility in how the Guidance is written and in how it is applied.
- There are also some instances of internal inconsistency in the Guidance. For example Section 2, paragraph 17 states that *"the board should undertake stress tests and reverse stress tests…"*, whereas Appendix 1, paragraph 29 implies that reverse stress testing is optional.

Question 9: Do you agree that the approach taken in Section 4 of the Guidance in implementing the disclosures in Recommendation 4 is appropriate? Is the term 'robustness of the going concern assessment process and its outcome' sufficiently clear? Do you agree that the approach the board should adopt in obtaining assurance about these matters is appropriately reflected in Section 3 of the Guidance? Do you agree that the board should set out how it has interpreted the foreseeable future of the purposes of its assessment? If not, why not and what changes should be made to the Guidance?

- The term "robustness of the going concern assessment" is not defined and is another example of new terminology introduced in this draft Guidance which may require further clarification.
- As noted in our covering letter, the "stewardship" assessment, as drafted in the guidance, is almost completely open-ended and a much broader test. We do not believe that introducing a separate going concern test is necessary.
- If the FRC pursues the approach in the draft guidance, then in order for Section 4 to be helpful, there would need to be greater clarification of the "stewardship" (items (a) to (c) in paragraph 1) and financial reporting elements of going concern (items (d) to (e) of paragraph 1) and the linkages between them.

Question 10: Do you agree that the proposed amendments to the auditing standards appropriately implement the enhanced role of the auditor envisaged in Recommendations 4 and 5? If not, why not and what changes should be made to the auditing standards?

- As indicated in our covering letter, we would be concerned if these changes resulted in the UK moving further from international auditing standards. The IAASB is already undertaking a wide-ranging project, covering all aspects of auditor reporting. Since the standards used to audit many of the world's listed companies are now set principally at international level, we consider that different ideas on how the auditor reports on going concern would be best discussed in an international forum.

Question 11: Do you agree that it is appropriate for the supplement to confirm that central bank support for a solvent and viable bank does not necessarily constitute a material uncertainty? In particular, do you agree that central bank support (including under ELA) may be regarded as in the normal course of business where the bank is judged to be solvent and viable? Do you agree that the approach set out in the Supplement to assessing whether there is a material uncertainty is appropriate and consistent with the general approach in the Guidance? If not, why not and what changes should be made to the Supplement to the Guidance?

- The Sharman Panel of Inquiry was established largely in response to the severe financial distress situations experienced by banks at the height of the financial crisis in 2007-08.
- Enhanced narrative disclosure of a bank's business model and analysis of where its funding is coming will help (as will adoption by UK banks of the recommendations in the November 2012 report of the Enhanced Disclosure Task Force sponsored by the Financial Stability Board). The enhanced analysis and disclosure of solvency and liquidity risks recommended by the Panel for all companies will also be beneficial in the case of banks. Cases of distress may be less likely to occur if assessments of solvency and liquidity are performed on a regular basis and built into the bank's normal control processes together with enhanced internal reporting routines.
- The Sharman report did illustrate that there is a valid debate to be had about the extent of going concern disclosure that is appropriate for banks and helpfully set out the legitimate twin public interest objectives of transparency for investors and financial stability.
- The proposed guidance confirms that liquidity support from central banks (where there is a high level of confidence that those facilities will be accessible by the bank to a sufficient extent and over a sufficient time period) may be a normal funding source for banks and reliance on such support does not necessarily mean that the bank is not a going concern or that material uncertainties should be disclosed or an emphasis of matter paragraph included in the auditor's report. Hence, under the guidance, the use of Bank of England facilities such as the Discount Window Facility (DWF) is not disclosable as a material uncertainty if the Bank has concluded the institution is solvent and it can repay what it borrows.
- However we consider that more thought needs to be given to the disclosures required more widely in corporate reports and the linkages between them, and not simply the going concern disclosures in isolation. For example, even if the Bank of England and an institution using the DWF are not related parties (which would if applicable likely trigger disclosures of material related party transactions), disclosure of substantial material borrowings from the Bank (which could run to £billions at off-market rates) would potentially need to be disclosed in order to comply with requirements in international accounting standards (for example IFRS 7 for liquidity disclosures) in order to give a true and fair view.

- We also observe that for banks, unlike other types of company, there seems to be no limit on what might be considered to be a "normal" funding source – these includes sources of finance that are not available to any other type of entity on equivalent terms.
- While the legitimate intention of the FRC and the UK regulatory authorities is, through this guidance, to preserve financial stability, we believe that greater consideration needs to be given to the context of the overall corporate reporting and disclosure regime. Non-disclosure of substantial support from Bank of England facilities needs to be considered also in relation to other disclosures required by accounting standards in order to give a true and fair view and to other disclosure obligations of directors. Without full consideration of the broader disclosure regime, it seems unreasonable to expect the directors or the auditors to conclude as a generality that such support will always be regarded as being in the normal course of business and hence not disclosable. The consequences of non-disclosure need to be viewed in the broader context and not simply in relation to the assessment and disclosure of going concern.
- The proposed Guidance does not remove the difficult judgments that must be made where a bank is subject to uncertainties that raise concern but where these are not yet at a level where the bank has entered discussions with the authorities about obtaining support. Disclosure of uncertainties in those circumstances may still result in a loss of market confidence in the bank, with the attendant consequences.

Question 12: Do you consider the proposed implementation date to be appropriate? If not, why not and what date should the application date be?

- For the reasons set out above, we do not consider that the proposed guidance should be implemented in its current form. We suggest an alternative approach be taken, which would avoid creating a separate "stewardship" test for going concern.
- If the FRC decides to proceed with its approach, we consider the proposed implementation date for the revised guidance (financial years beginning on or after 1 October 2012) to be challenging, particularly since the guidance features many new concepts and terminology which neither companies nor auditors are used to applying in the assessment of going concern.
- A yardstick to use in considering the reasonableness of the implementation date is whether there will be at least one meeting of the audit committee sufficiently far in advance of the company's year-end to enable management, the committee and the auditors to discuss what amendments to internal processes and routines may be required and to make any changes. While this may conceivably be achievable for those companies with 31 December 2013 year-ends, it seems impractical for companies with 30 September 2013 year-ends. Assuming the final guidance is published at the end of June, those companies would have only a very few months to prepare.
- We therefore suggest that the implementation date be put back at a minimum to apply for financial years beginning on or after 1 January 2013.
- We are aware of the FRC 's intention to introduce a 'package' of a number of changes to the Corporate Governance Code, associated guidance for companies, and auditor

reporting so that they become effective later this year. However we see no inherent reason why these Sharman proposals must be implemented at the same time as some of the other measures. It would in our view be preferable to take the time necessary to better position and refine the approach to going concern and risk reporting

Question 13: Do you believe that the Guidance will deliver the intended benefits? If not, why not? Do you believe that the Guidance will give rise to additional costs or any inappropriate consequences? For example, as compared with the 2009 Guidance, do you believe that the Guidance will give rise to fewer companies being judged to be a going concern and/or more companies disclosing material uncertainties? If so, what are the key drivers and can you give an estimate or indication of the likely cost or impact? Do you believe that such additional costs or impact would be justified by the benefits?

- For larger listed companies, we believe the FRC's proposed approach would result in added costs but the increment would be relatively low in relation to the resources already committed to planning and budgeting.
- For SMEs, the proposed approach is in our view too elaborate and will result in added costs as well as questionable benefits. Subsidiary companies are not discussed in the guidance, but similar concerns about costs and benefits may apply to them also.
- However, for the reasons set out above, we consider that the framework proposed in the Guidance is over-complicated for all companies and the benefits of enhanced narrative reporting and improved information for investors could be better obtained by other means.

Question 14: Do you agree with the approach to SMEs in the Guidance? If not, why not and what changes should be made to the Guidance?

- The approach taken in the consultation paper is to set out a framework for listed companies and indicate, in paragraphs 2.35-2.38 that SMEs might do less, without defining what "less" is.
- This may leave SMEs unsure as to the extent to which they might adopt a less sophisticated approach and hence push them to perform a more extensive assessment than is warranted by their circumstances. This will affect the cost/benefit consideration for SMEs.

Question 15: Are there any other matters which the FRC should consider in relation to the Guidance and the Supplement? If so, what are they and what changes, if any, should be made to address them?

- The proposals could potentially have an impact on directors' duties and duties of care. We have not considered this aspect in detail, but it is something the FRC may wish to give appropriate attention to before finalising the guidance.
- In finalising Section 3 of the guidance, the FRC might consider whether to include a reference, in connection with the board or risk committee's review of the effectiveness of risk management and internal control systems, to whether appropriate attention is

paid to controls and governance around insurance coverage where this is a potential mitigating factor to the risks to the sustainability of the business.

- In the section on solvency and liquidity risks in Appendix 1, footnote 30 to paragraph 21 states that "*it is the market-perceived value of the assets and liabilities of a company…., not the accounting book values, that defines the solvency of the entity.*" We question how, in practical terms, it would be possible for management or the auditors to be able to perform work to assess the "market-perceived" value of assets and liabilities.