The Sharman Inquiry

Going Concern and Liquidity Risks: lessons for companies and auditors

Final report and recommendations of the Panel of Inquiry

June 2012

Enquiries should be addressed to:

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

E-mail: sharman.secretariat@frc.org.uk

Secretary to the Panel: Marek Grabowski 020 7492 2325

Contents

The Lord Sharman

HOUSE OF LORDS

I am pleased to submit our final report about the lessons to be learned for companies and auditors in addressing going concern and liquidity risks. We have made five recommendations which we hope will improve the management of such risks in the future.

The proper management of going concern is fundamental to the operation of limited liability companies. Sanctioning of that limitation by law is of huge importance in encouraging investment through such companies. However, the privilege must not be abused. In managing going concern risks in pursuit of success, directors must be careful, on the one hand, to balance their duties to shareholders and other stakeholders, particularly creditors. On the other hand, the expectation that they will not fail must not be so high as to inhibit sensible risk taking that is critical to the growth and maintenance of economic activity.

As a result, the aim of the directors' assessment and reporting of going concern risks is not primarily to inform outsiders of distress. Rather, it is to ensure that the company is managed to avoid such distress, while still taking well-judged risks. That judgment must rest with the directors, and we must aim to encourage them to discharge their duties in that regard with skill, and in good faith. Therefore, in reaching our recommendations, and in keeping with the responses we have received, our primary purpose has been to reinforce responsible behaviour in the management of going concern risks for companies.

We would suggest that this focus on behaviour, is fundamental in considering regulations as they apply to going concern, and indeed may have application in other areas of accounting and audit, both in the UK and internationally.

I wish to give my personal thanks to fellow Panel members, Roger Marshall and David Pitt-Watson. They have provided a healthy contrast to my own views on corporate reporting and governance in relation to going concern. We also thank the scores of people who responded to our questions, including senior policy makers from the UK and abroad, as well as Marek Grabowski and Hazel O'Sullivan of the FRC for their outstanding support. We trust that our recommendations will enable the FRC to further improve the reporting regime and related guidance for companies and auditors in relation to these matters.

Colin Sharman.

Lord Sharman of Redlynch

Introduction and Summary

1. Responses to our Preliminary Report overwhelmingly supported our view that the aim in requiring directors and auditors to consider and report about going concern should be to create a framework which encourages appropriate corporate behaviours. It should not inhibit sensible risk taking that is critical to the growth and maintenance of economic activity. It cannot therefore eliminate the risk that economic or financial distress will arise or the possibility of failure. It should aim to support better risk decision-taking; ensure that investors and other stakeholders are well-protected and informed about those risks; and sustain an environment in which directors recognise, acknowledge and respond to economic and financial distress sooner rather than later.

2. These behaviours should be a by-product of the going concern framework. If that framework is right, the assessment process should assist the directors in understanding, managing and articulating the risks to the status of the company as a going concern that they face and take in promoting its success. The resulting disclosures should enhance investors' and other stakeholders' understanding of the directors' behaviour in relation to going concern risks and uncertainties and their ability to challenge where they consider appropriate. This transparency should, in turn, reinforce responsible behaviour in directors.

3. The Panel believes that these behaviours will be incentivised through corporate governance, narrative and financial reporting and the audit if:

   - The going concern assessment process, the risks to the company's status as a going concern and the rationale for the directors' conclusions about this are always transparent, not only when there are heightened risks;

   - The assessment process and disclosures are focussed on the right issues (whether or not there is economic or financial distress that would undermine the future success of the entity) by having an appropriate definition of what a going concern is and clarity as to the thresholds to be used and the purposes of the required disclosures, which are all consistently understood; and

   - The going concern assessment process is integrated with the directors' business planning and risk management processes; it therefore encourages the directors, when they are addressing the risks to the business model and strategy that they face and take in promoting the success of the company, to consider the implications of their decisions for its going concern status.

4. Our final recommendations are set out on pages 10 and 11, with supporting commentary set out below.

Always making the going concern assessment process, risks and conclusions transparent

5. The Panel identified two purposes for the going concern assessment and disclosures. The first purpose is to establish and disclose information about the going concern status of the entity that is needed for the financial statements to give a true and fair view. This, in itself, comprises two elements. The first is the information necessary to make the binary determination as to whether the going concern or a liquidation basis of accounting[1] should be used. The threshold of distress at which a liquidation basis must be adopted is very high in the UK GAAP and IFRS frameworks. Accordingly, the second element of information these frameworks require is additional disclosures about material uncertainties when the going concern basis of accounting has been adopted but there is an especially high level of risk (a material uncertainty) that the company may not be able to remain a going concern for the foreseeable future.

6. The second purpose is to provide information to stakeholders about the economic and financial viability of the company and to help demonstrate the directors' stewardship and governance of the company in that respect. The Panel believes that this information element should include the directors' conclusion about the going concern status of the company (as required by the Code and the Listing rules) together with relevant information about the company's business model, strategy and principal risks (as required by the Code and Companies Act) to contextualise and explain that conclusion, in addition to the information about the appropriateness of the going concern basis of accounting and material uncertainty disclosures required by the accounting framework, with appropriate links and explanations. The audit committee report should also illustrate the robustness of the going concern assessment process and any limitations it may have had.

7. The information supporting the first purpose must, by definition, be included in the financial statements. The Panel believes that the additional information required to support the second purpose is best included in the narrative report and that this purpose and approach is very consistent with those of the FRC's ECS initiative. The information should be specific to the entity and avoid standardised language. The directors should be free to rely on their judgment, experience and understanding of the underlying business in making their assessment and in disclosing what they believe will be most relevant to shareholders and other stakeholders. The information should always be provided, not just when there are material uncertainties about the going concern status of the entity. Accordingly, the Panel has recommended that these disclosures should always be given and should be integrated with the ECS disclosures – see **Recommendation 4**.

[1] Sometimes referred to as a 'break-up' basis of accounting, a 'liquidation' basis of accounting is one that is appropriate when 'management either intends to liquidate the entity or to cease trading or has no realistic alternative but to do so'. It would generally reflect values of the assets and liabilities that are expected to result from selling and realising them piecemeal rather than continuing to operate them or sell them as an integrated business. Liquidation basis accounting is not standardised under UK GAAP or IFRS and, for that reason, both of those accounting frameworks require details of the actual basis adopted to be disclosed when applicable.

8. In continuously providing background and context about the risks to the going concern status of the entity, as part of a fuller picture of the principal risks the entity is taking and facing in pursuit of its business model and strategy, this information should reduce the propensity for adverse developments and, where they do occur, for them to take the market by surprise. In turn, this may remove some of the stigma attached to an emphasis of matter paragraph in the auditor's report and engender a more measured response from stakeholders when such developments occur.

9. In addition, reporting by audit committees and auditors on the directors' assessment of going concern should engender greater confidence in the process that is undertaken.

Establishing a common understanding of purpose, thresholds and what constitutes a going concern

10. It is important that what constitutes a going concern and the relationships between the elements of information relating to the entity's going concern status described above – and their purposes and the thresholds used – should be clearly and consistently understood and applied. The Panel found that the descriptions of these matters in the various sources (UK GAAP and IFRS, auditing standards, the Code and guidance for directors and auditors) are at worst inconsistent and at best open to different interpretations, and are in fact interpreted differently, by different people. While recognising the judgmental nature of going concern, such inconsistencies may undermine the effectiveness of the assessment process and the disclosure about the entity's going concern status and may create expectation gaps.

11. Accordingly, the Panel has recommended that the FRC should seek to engage with the IASB and the IAASB, ideally to agree a common international understanding of the purposes of the going concern assessment and financial statement disclosures about going concern, and of the related thresholds and descriptions of a going concern, and should clarify these matters (and how they articulate with the stewardship purpose of the assessment and related disclosures) in the UK standards and guidance, if possible in light of that consensus – see **Recommendation 2**.

12. In developing this recommendation, we recognised the concerns which a good number of respondents raised, that the FRC should seek to take the international community with it rather than making changes to UK accounting and auditing standards and then seeking to influence the international community to adopt similar amendments.

Integrating the going concern assessment with business planning and risk management

13. The directors' going concern assessment process should be integrated with their on-going business planning and risk management processes, so that the thinking which emerges from their going concern assessment informs their risk decision making and better enables them to recognise and respond to signs of economic and financial distress, on a continuous

basis. The accounting information (the appropriateness of the going concern basis of accounting and the material uncertainty disclosures) and the stewardship disclosures should fall naturally out of this continuous process whenever an annual report and accounts or an interim report is prepared for publication.

14. The evidence we received confirmed that for many the principal focus of the going concern assessment process is on liquidity and that, outside the financial services industry, there is little focus on solvency. The Panel believes that consideration of solvency risks is important too, because it underpins the ability to obtain and maintain debt funding as well as equity funding for the business. Therefore an understanding of how the likely future success of the business will be perceived by providers of debt and equity funding and trade credit is an important element of the assessment of liquidity risk. Solvency risk on the other hand is about the viability of the business model and the maintenance of capital. Solvency risks are therefore longer term and may be more qualitative and judgmental, whereas liquidity risks tend to be more short term and more quantitatively based.

15. One particular lesson from the crisis has been that stress testing[2] is a powerful tool to lean against the natural optimism of management in thinking about the future success of the business; reverse stress testing[3] can be especially so.

16. The Panel doesn't believe that the nature of stress tests should be prescribed. Rather, directors should be encouraged to tailor them to the circumstances of the entity and the business environment at the time of the assessment, taking account of their assessment of the economic outlook, business cycles and the period over which the identified solvency and liquidity risks are likely to evolve. In making their going concern assessment, they should also be encouraged to consider their appetite for risk taking, and that of their shareholders and other stakeholders, and their likely responses to future developments, in the context of their duties and responsibilities, which are principally set out in the Companies Act[4], as well as those more particular responsibilities established by other branches of law or regulation.

17. The Panel also heard evidence that IFRS had resulted in a move away from prudence towards neutrality in providing financial information. Prudence involves weighting downside risks more heavily than upside opportunities. The Panel concluded that, although financial reporting may benefit from this shift in terms of enhanced comparability, prudence remains important in making going concern assessments. Therefore, in making such judgments, directors should seek to ensure that the company is solvent and liquid on a prudent basis.

18. In light of these considerations, the Panel has made a number of recommendations about the nature of the going concern assessment process – see **Recommendation 3**.

[2] Stress testing enables the directors to assess the effect of a combination of pessimistic but plausible estimates or assumptions on the company's solvency and liquidity.
[3] A reverse stress-test seeks to identify and consider scenarios that would lead to a firm's business model failing.
[4] In particular, Section 172 Companies Act 2006

Enhancing the role of the auditor

19. In finalising our recommendations, we reconsidered our preliminary recommendation to consider moving away from the three category model for auditor reporting (clean report, emphasis of matter paragraph or disagreement with the directors' assessment), in light of strong feedback from a good number of respondents that the emphasis of matter paragraph was an important option for the auditor.

20. The Panel's original suggestion to consider this change was made with a view to countering the concern that a more transparent approach to reporting going concern risks may be restrained by fear that this may attract an emphasis of matter paragraph which in turn may become a self-fulfilling prophecy. The Panel believes, on balance, that in practice the enhanced narrative reporting that we have recommended (Recommendation 4) may sufficiently counter this fear without needing to remove the emphasis of matter signalling by the auditor. We also note that, even if the auditor were not required to signal material uncertainties with an emphasis of matter paragraph, the accounting standards would still require the directors to signal them.

21. The Panel's final recommendation in relation to the auditor's role is therefore an enhanced one in which, in addition to addressing the basis of accounting and material uncertainty disclosures, the auditor also considers the directors' going concern assessment process and narrative disclosures about the going concern status of the entity and includes a statement in the auditor's report as to whether the auditor has anything to add to or emphasise in relation to the disclosures made by the directors about the robustness of the process and its outcome – see **Recommendation 5**.

Enhancing the FRC's monitoring of and response to corporate failures and near misses

22. There was also very strong support for our preliminary recommendation that the FRC should take steps that would enable it to take a more systematic approach to learning lessons relevant to the scope of its functions when significant companies fail, by assessing the underlying circumstances through its own inquiries and working with other regulatory agencies. In finalising this recommendation, we have acknowledged, as a number of respondents pointed out, that it may be just as important to learn lessons from 'near misses' as from those companies that actually fail - see **Recommendation 1**.

23. The Panel does not intend that this recommendation should create a regime where the FRC automatically carries out its own investigation of every significant company that fails or nearly fails. Judgment will be needed to identify circumstances that suggest there are significant unanswered questions. The Panel supports the FRC's recent proposals, as part of its reform process, to undertake supervisory inquiries as a means of taking forward this recommendation. In finalising this recommendation, the Panel also considered further what information might be available or made available to the FRC from work undertaken

by other parties on failed and distressed companies. We have set out in the body of this report a number of specific suggestions for the FRC to consider further in this regard.

Scope of the Panel's recommendations

24. There were quite varied responses to our question about whether the Panel's recommendations should only be applied to listed companies or also to other entities and, if so, which. A number of commentators believed that it would be desirable to have consistent application across all entities, as the principles are not dependent on the type or size of the company and this approach would avoid inefficiency and confusion. Others felt that the burden of work that is attached to the Panel's recommended improvements in corporate reporting may be excessive for some smaller non-listed entities and either suggested restricting the enhanced disclosures to listed entities or to a combination of listed entities and some other types of entity.

25. We are proposing that initially Recommendations 4 and 5 should be limited in scope to those companies that the FRC's ECS requirements are applied to. Implementation of these recommendations would be through amendment to the Guidance for Directors, the Guidance on Audit Committees and a number of the UK auditing standards.

26. Recommendations 2 and 3 can be implemented initially through amendments to the Guidance for Directors. The Guidance for Directors applies to all companies but it notes that directors should apply the guidance in a manner proportionate to the nature of their business. Companies that follow this guidance will therefore be entitled to take into consideration the nature of their governance arrangements, such as not having an audit committee, and to tailor their assessment and disclosures to their circumstances.

27. It will be for the FRC, in taking forward these proposals, to determine the most appropriate approach to, and timing of, any changes that may be necessary to reflect the clarifications and amendments set out in Recommendation 2 in the UK accounting and auditing standards and related guidance. The FRC may seek international agreement on the clarifications and amendments suggested by the Panel in Recommendation 2, in order to avoid unnecessary divergence from international standards.

A special going concern disclosure regime for banks?

28. We asked, in our preliminary report, whether the banking sector should be treated differently in relation to going concern disclosures because of the especially intense nature of the solvency and liquidity risks that such entities are exposed to. Respondents who answered this question had mixed views. Investors generally felt that secrecy about financial support did not benefit shareholders. The Panel has given further thought to this issue and believes that it should not be necessary to have a separate going concern disclosure regime for banks.

29. The Panel believes that in taking forward the definition of a going concern, the FRC would need to consider making clear that liquidity support from central banks may be a normal funding source for a bank and therefore reliance on such support if reasonably assured, does not mean that the bank is not a going concern or that material uncertainty disclosures or an emphasis of matter paragraph are required. The Panel considers that this is critical to its conclusion that it should not be necessary to have a separate going concern disclosure regime for banks.

30. The key issue for banks is that in practice <u>any</u> signalling of material uncertainties about their going concern status may trigger a liquidity shock and potentially a run on the bank. Given the intensity of their gearing and maturity transformation, this may create a need to call on Government or Central Bank support.

31. Where there are concerns, the directors and auditors should be in close dialogue with the Bank of England and the FSA (or PRA). They should seek to understand the status of escalation of supervisory intervention under the Proactive Intervention Framework, the factors giving rise to this and the actions being taken to address them. They should seek to understand whether the FSA (or PRA) believes that the entity should be referred into the SRR (and, if not, why not).

32. The Bank of England aims to provide adequate liquidity insurance facilities to the banking system. Where access to the Bank of England's liquidity facilities and/or ELA is envisaged, the directors and auditors would need to satisfy themselves that those facilities would be accessible by the bank to a sufficient extent and over a sufficient time period to enable them to conclude that the entity will remain a going concern for the foreseeable future. We note that in order to access liquidity from the Bank of England (absent a direction from the Chancellor and a Government indemnity to the Bank of England), a bank needs to be judged both solvent and viable by the Bank of England. Therefore, particular attention must be given by bank directors to ensuring that the bank is and will remain solvent, through the cycle, if they are to assume that they can access Bank of England facilities. This judgement is one for the directors alone. However the directors and auditors should be in close dialogue with the Bank of England and the regulator in these circumstances.

33. Where a bank envisages needing to avail itself of Bank of England facilities in the face of systemic issues, it is possible that other banks may be drawing on those facilities and disclosure of such reliance may not trigger adverse reactions from the market, even if such disclosures were considered necessary. However, when a bank faces uncertainties as to its ability to access Bank of England facilities as a result of entity-specific issues, disclosure may be expected to result in a run on the bank and the expectation that such disclosures are to be made may in itself therefore lead to the conclusion that the proposed disclosure is sufficient grounds to trigger the bank being put into the SRR.

34. That such a situation may arise may, of course, be undesirable but it is a consequence of the fact that the directors and auditors are responsible for making their own judgments

about the future solvency and viability of the bank and cannot simply defer to the judgment of the Bank of England or Ministers. Whilst this situation remains a possibility, it is highly desirable that close dialogue between the various players should ensure that a consensus judgment is reached, where possible.

35. Where a bank is, or envisages that it may be, reliant on Government or Bank of England support but the Bank of England is or would be unable to conclude that the entity is both solvent and viable, it seems likely that referral into the SRR will be triggered, either on the facts or because the directors or auditors of the bank conclude that disclosure is necessary and the expectation of that disclosure triggers the referral.

36. The Panel also believes that its recommendation to improve the disclosures in the narrative reporting provided in the annual report may, at least over time, make disclosures of liquidity sources and the risks attached to them normal practice, so that reliance on the Bank of England's permanent liquidity insurance facilities, and perhaps even ELA, will come to be seen, rightly, as a natural part of the banking system for solvent banks that provides financial stability. Whilst it signals liquidity stresses that need to be understood, it should not always ring alarm bells of impending failure.

A separate financial reporting and auditing regime for banks?

37. We also asked whether commentators supported the suggestion by some respondents to the Call for Evidence that there should be a separate financial reporting and auditing regime for the banking sector. Most commentators thought that, as financial reporting and auditing standards have been developed in order to be applicable to all types of business, no separate industry specific standards should be developed as this would restrict the comparability of corporate financial reports.

38. It was pointed out that the growing regulatory requirements for banks already offer the potential to develop an incremental (if not separate) financial reporting and auditing regime through the regulatory returns that are required. For example, the regulator has the ability to require banks to provide incremental information that may also be relevant to the markets. Publication of such information on a bank-by-bank or industry-wide basis is one possible way to leverage market forces to drive appropriate behaviours in this sector.

39. However, if this approach is to be taken, it will be important to consider the relevance of that information to market participants and whether it should be more integrated with the financial statements and narrative reporting already required to be provided to the markets. For this reason, the FRC and BIS may wish to remain engaged with the regulators as they consider taking these matters forward.

40. In the preliminary report the Panel suggested that a bank-specific appendix to the Guidance for Directors may be appropriate. This was supported by a number of commentators and we believe this is something the FRC should consider taking forward.

Glossary of abbreviated terms

BIS The Department for Business, Innovation and Skills.

ECS *Effective Company Stewardship – Enhancing Corporate Reporting and Audit* – a paper issued by the FRC in January 2011 making recommendations aimed at improving the dialogue between company boards and their shareholders.

ELA Emergency Liquidity Assistance –financial support provided by the Bank of England that goes beyond its permanent liquidity insurance facilities.

FRC The Financial Reporting Council.

FRS 18 Financial Reporting Standard 18: *Accounting Policies* – issued by the Accounting Standards Board applicable to financial statements prepared under UK GAAP.

FSA The Financial Services Authority.

Guidance for Directors The FRC's guidance: Going Concern and Liquidity Risks: Guidance for Directors of UK Companies 2009.

IAASB International Audit and Assurance Standards Board.

IAS 1 International Accounting Standard 1: *Presentation of Financial Statements* – sets requirements for the presentation of financial statements prepared under IFRS.

IASB International Accounting Standards Board.

IFRS International Financial Reporting Standards as adopted in the EU – pronouncements published by the IASB which have been adopted in the EU.

ISA International Standard on Auditing.

PRA The Prudential Regulatory Authority, which is currently expected to come into play in 2013 as a subsidiary of the Bank of England

SRR The Special Resolution Regime for banks introduced under the Banking Act 2009.

The Code *The UK Corporate Governance Code*, published by the FRC in May 2010, which sets out standards of governance for listed companies.

UK GAAP UK Generally Accepted Accounting Practice.

UKLA The UK Listing Authority - The FSA, acting as the competent authority under Part VI of the Financial Services and Markets Act 2000.

Final recommendations of the Panel

Recommendation 1

The Panel recommends that the FRC should take a more systematic approach to learning lessons relevant to its functions when significant companies fail or suffer significant financial or economic distress but nonetheless survive. This might be achieved through a combination of approaches, including selective inquiries by the FRC (alone or, where practical and expedient to do so without undue delay, in conjunction with BIS, other regulatory authorities or others appointed by them to investigate or inquire into such circumstances). The FRC should consider whether it has adequate protocols with BIS and with other regulatory authorities to enable it to do so.

Recommendation 2

The Panel recommends that:

a) The FRC should seek to engage with the IASB and the IAASB, ideally to agree a common international understanding of the purposes of the going concern assessment and financial statement disclosures about going concern, and of the related thresholds and descriptions of a going concern, in the international accounting and auditing standards;

b) The FRC should seek to clarify the accounting and stewardship purposes of the going concern assessment and disclosure process and the related thresholds for such disclosures and the descriptions of a going concern in the Code (and related guidance for directors and auditors) and in FRS 18 and ISA (UK & Ireland) 570, if possible in line with such international consensus; and

c) The FRC should engage with the UKLA to seek to maintain the existing congruence of the Code and the related guidance for directors with Listing Rule 9.8.6 R (3), in light of these changes.

Recommendation 3

The Panel recommends that the FRC should review the Guidance for Directors to ensure that the going concern assessment is integrated with the directors' business planning and risk management processes and:

a) includes a focus on both solvency and liquidity risks, whatever the business. In relation to solvency risks, this should include identifying risks to the entity's business model or capital adequacy that could threaten its survival, over a period that has regard to the likely evolution of those risks given the current position in the economic cycle and the dynamics of its own business cycles;

b) may be more qualitative and longer term in outlook in relation to solvency risk than in relation to liquidity risk; and

c) includes stress tests both in relation to solvency and liquidity risks that are undertaken with an appropriate level of prudence. Special consideration should be given to the impact of risks that could cause significant damage to stakeholders, bearing in mind the directors' duties and responsibilities under the Companies Act 2006.

Recommendation 4

The Panel recommends that, in taking forward its work on reporting under ECS, the FRC should move away from a model where disclosures about going concern risks are only highlighted when there are significant doubts about the entity's survival, to one which integrates going concern reporting with the ECS proposals through seeking to ensure that:

a) the discussion of strategy and principal risks always includes, in the context of that discussion, the directors' going concern statement and how they arrived at it; and

b) the audit committee report illustrates the effectiveness of the process undertaken by the directors to evaluate going concern by:

   i. confirming that a robust risk assessment has been made; and

   ii. commenting on or cross-referring to information on the material risks to going concern which have been considered and, where applicable, how they have been addressed;

and recommends that the FRC should amend the standards and guidance for directors and auditors accordingly when the ECS proposals have been finalised.

Recommendation 5

The Panel recommends that, as part of its work on auditor reporting arising from the ECS proposals, the FRC should:

a) consider moving UK auditing standards towards inclusion of an explicit statement in the auditor's report as to whether the auditor has anything to add to or emphasise in relation to the disclosures made by the directors about the robustness of the process and its outcome, having considered the directors' going concern assessment process; and

b) seek to encourage the IAASB to accommodate this approach in the ISAs.

Background

41. The Panel of Inquiry was launched by the FRC in March 2011 and the Panel's Preliminary Report and Recommendations were published in early November 2011 together with a number of consultation questions5. The background to the Panel of Inquiry and the Panel's detailed Terms of Reference are included respectively in Chapter 2 and Appendix 1 of the preliminary report.

42. Thirty written responses to the related consultation were received by the Panel. These are listed in Appendix 2 and are available on the Panel's website[6]. The Panel has also met with a number of organisations to discuss the preliminary recommendations and how they might be best implemented. The respondents were as follows:

Respondent perspective	**Number**
User - Investors, investor representative bodies, other user representative body	7
Member of Parliament	1
Corporate (companies, directors[7], internal audit[8], industry body)	12
Accountancy profession (firms and membership bodies)	10
Total	**30**

43. Most respondents provided specific responses to Questions 1 and 3 and commented separately on whether or not they supported each (or most) of the preliminary recommendations in responding to Question 2; and approximately two thirds responded to Question 4 about the regime for banks. However, some of the responses were more narrowly focused. Three of the responses (one other User; one Corporate – financial services industry body; and one Accountancy profession – non-UK membership body) only addressed certain of the recommendations and another (Corporate – former internal auditor) commented generally on the relevance of the Inquiry but did not provide specific responses to Questions 1 to 4. These four respondents are therefore usually included in the analysis of responses below as not specifically agreeing or disagreeing.

44. The remainder of this final report provides a summary of the comments received by the Panel of Inquiry on the questions asked in its Preliminary Report, including reactions to each of the preliminary recommendations in response to Question 2, and how the Panel has responded to these comments in arriving at its final recommendations.

[5] See: http://www.frc.org.uk/images/uploaded/documents/The%20Sharman%20Report%20-%20final%200311111.pdf
[6] See: http://www.frc.org.uk/about/sharmaninquiry.cfm
[7] Includes a former director
[8] Includes a professional body and a former internal auditor

Question 1: Do you agree with the Panel's overall conclusion that the going concern process and disclosures should be designed to encourage appropriate business behaviours?

45. The Panel commented in the Preliminary Report (paragraph 3) that:

> *"The aim in requiring consideration of and reporting about going concern (and therefore the design of these requirements) should not be to discourage sensible risk taking or to eliminate the possibility of bankruptcy. That would damage the entrepreneurial spirit so critical to the growth and maintenance of economic activity. Rather, the aim should be to create a framework that encourages appropriate corporate behaviours, including:*
>
> - *better risk decision-taking;*
> - *ensuring that investors and other stakeholders are well-informed about those risks; and*
> - *sustaining an environment in which economic and financial distress is recognised and acknowledged sooner rather than later."*

46. There was overwhelming support for this position, with twenty (6U; 1MP; 6C; 7A)[9] of the twenty three (6U; 1MP; 7C; 9A) respondents to Question 1 agreeing with the proposed aim.

47. A key theme in the comments from those who agreed is that the desired better behaviours are principally a by-product of the framework for better disclosures. Getting the disclosure framework right will therefore be important. Key points made by respondents in this regard include that the framework should be designed to ensure that:

- disclosures are informative not only about risks and uncertainties and the directors' related conclusions but also about how those conclusions were reached;
- in making their assessments, directors are able to rely on their judgment, experience and understanding of the underlying business;
- disclosures provide a better understanding of the assessment process and its limitations;
- requirements are not overly prescriptive lest they drive boilerplate – some respondents suggested that the recommendations may be overly prescriptive, with others warning against making them so in their implementation; and
- narrative disclosures about risks should remain cohesive and integrate not append disclosures about the going concern assessment.

[9] Throughout this report, where numbers of respondents are referred to, the breakdown of those respondents by Users, Member of Parliament; Corporate and Accountancy profession are given in brackets in the form (#U; #MP; #C; #A), where # is the respective number of each category of respondents.

48. If these matters are addressed, the framework should support good behaviours because:

- the need to make these disclosures would assist directors in understanding and articulating the status of their business as a going concern; and
- the resulting disclosures would enhance investors' and other stakeholders' understanding of the directors' underlying business behaviours in relation to going concern risks and uncertainties and would enable them to challenge where they consider appropriate.

49. The Panel agrees with these comments and believes that they capture the essential basis for establishing the desired new framework.

50. One respondent (1U) asked, in relation to the last bullet point of the proposed aim, who did the Panel envisage should recognise and acknowledge distress sooner rather than later? The Panel primarily sees this aimed at directors. As set out in the Preliminary Report, evidence from lending bank workout teams suggested that early recognition and engagement by management with the issues giving rise to distress will raise the likelihood of a successful turnaround.

51. One (1C) of the three (1C; 2A) respondents who did not agree with the aim proposed by the Panel took the view that there are no barriers within the current reporting environment and that fuller disclosures are not necessary.

52. The other two (2A) suggested that business behaviour should be driven by the directors' fiduciary duties and their company law and insolvency law responsibilities rather than by the going concern requirements. Furthermore, one (1U) respondent who agreed with the proposed aim commented that they supported the proposed aim if the desired behaviours included "stewardship of the shareholders' money for a foreseeable future".

53. The Panel believes that stewardship as described by this respondent is part of the directors' fiduciary duties and legal responsibilities. The Panel is not suggesting that the going concern framework should override those duties and responsibilities. Rather, the framework should encourage directors to consider their approach to assessing and reporting on going concern risks and uncertainties in the context of those duties and responsibilities. In turn, this should ensure that the going concern framework supports rather than leans against those duties and responsibilities. The Panel drew particular attention to the wider nature of the directors' responsibilities in the last bullet point of preliminary recommendation 3.

Question 2: Do you support each of the five recommendations set out in Chapter 1 of the Preliminary Report?

Recommendation 1: Taking a more systematic approach to learning lessons relevant to the FRC when significant companies fail

54. In its preliminary report the Panel noted the limited availability of public reports into high impact cases of corporate collapse in the UK. Additionally, in undertaking a review of published research into aspects of going concern, it was clear that there is limited on-going analysis carried out of the underlying causes of individual cases of corporate collapse.

55. The Panel recommended that a more systematic approach be taken by the FRC to learning lessons relevant to its functions, when significant companies fail, as this could highlight areas where improvements in the FRC's standards, codes, guidance or monitoring processes might be necessary and/or where research might prove useful.

56. This recommendation was very strongly supported, with 24 (6U; 1MP; 8C; 9A) respondents agreeing in principle with the recommendation and the remaining 6 (1U; 4C; 1A) not addressing this recommendation.

57. There were a number of comments on the proposal from those who supported it. Amongst users, comments reinforced the need to avoid duplication in investigations, to allow sufficient time to consider the underlying issues and to identify lessons on a timely basis rather than after judicial and disciplinary processes have been completed. The Panel's view is that whilst the FRC should seek to avoid unnecessary duplication with other agencies, it will also need to weigh against that the need to learn lessons early and to meet its regulatory objectives.

58. Corporate respondents reinforced the need for a constructive focus on genuine areas of interest, so as to avoid constant change to guidance, and flagged the difficulties individuals could have in responding to enquiries whilst needing to protect their personal positions in the event of potential judicial or disciplinary investigation. One commentator (1C) suggested that reviews might also be undertaken of 'near misses', whilst recognising the difficulties that exist in identifying such entities.

59. Accountancy profession respondents urged the Panel to remember that it is axiomatic that some companies will fail and that there won't always be a lesson to learn. They also suggested: that this should not go so far as to represent a market regulatory role; that criminal and civil legal actions should take precedence; that responsibilities and timescales should be clearly defined; and that it should not be used to launch 'fishing expeditions'.

60. In Appendix 4 to the Preliminary Report (on research), the Panel noted that financial distress is not easy to define unambiguously. Entities may experience economic or financial distress without necessarily approaching insolvency and other outcomes than insolvency may resolve the distress. For example, restructuring or takeover by another

entity may enable the business to continue in a different form. The Panel agrees with the suggestion that near misses should also be considered in taking forward this recommendation. In order to do so, the FRC will need to develop a means of identifying and considering instances of companies suffering significant distress whether or not that distress is resolved and, if so, whatever the manner of resolution.

61. The following two approaches to identifying financial distress that are used in research may be helpful in this regard:

- monitoring trigger events, such as implementing an emergency rights issue;
- monitoring the symptoms of financial distress, such as reported losses or negative share price movements.

62. The Panel does not intend that this recommendation should create a regime where the FRC automatically carries out its own investigation of every significant company that collapses. Rather, a selective approach is envisaged in which the FRC monitors the incidence and resolution of significant financial distress in entities within the scope of its remit and triggers an exercise to learn appropriate lessons relevant to its functions (but not to investigate wider commercial reasons for failure) when circumstances suggest there are significant unanswered questions or that the experience of one or more entities may be valuable more widely.

63. The FRC has announced plans, as part of its proposed reform process, to undertake supervisory inquiries to provide at an early stage an understanding of the reasons for the collapse or near collapse of a public interest entity or other issue affecting corporate governance or reporting. The aim of these supervisory inquiries is to assess whether any further regulatory or other action should be taken by the FRC, including whether any improvements should be made to the corporate reporting and governance regime, or whether more formal disciplinary proceedings should be set in hand. The Panel supports this approach as a means of taking forward this recommendation.

64. As part of its follow up to responses to the consultation, the Panel has further considered what information might be available or made available to the FRC from work already undertaken by others on failed and distressed companies.

65. Where a supervisory inquiry is commenced, relevant sources of information may include the following, where available at that time[10]:

- Publicly available financial and other information, including the financial statements;
- The audit files to the extent this is possible under the FRC's powers;

[10] The need to undertake such inquiries on a timely basis may make it impractical or inexpedient to delay commencement until some of these sources (such as Insolvency Practitioners' reports on directors' conduct and Inspectors' reports) become available. They may, nonetheless, be helpful subsequently in updating preliminary work undertaken.

- Discussions with the Insolvency Service. The Insolvency Service receives reports on the conduct of directors of insolvent companies, from appointed insolvency practitioners, and also carries out its own investigatory work in relation to 'live companies' where appropriate;

- Reports by Inspectors appointed from time to time by the Secretary of State under the provisions of the Companies Act 2006;

- Discussion with the appointed insolvency practitioner where the company is in an insolvency procedure. This may be helpful generally given the wide ranging role of the insolvency practitioner and may be especially helpful where individual directors and others are unwilling or reluctant to provide information. The FRC would need to consider further whether it would need to take any steps to secure the right to receive information from this source;

- Discussion with the directors or former directors of the company. The Panel recognises that there may be some reluctance on the part of individuals who may be subject to potential judicial or disciplinary actions to provide such information and the FRC would need to consider the circumstances in which it would be able to access information from this source ;

- In order to avoiding unnecessary duplication, and where practical and expedient to do so without causing undue delay, obtaining information from, or making inquiries through, other regulators or investigators appointed by them, or through inspectors appointed under the Companies Act.

- The FRC would also need to consider whether it has adequate protocols with BIS and with other regulatory authorities to enable it to access these sources of information.

66. Information on companies which have failed and the directors of those companies may be made available through the following:

- Reports on the company's affairs filed by the insolvency practitioner at Companies House. The format of this reporting will vary depending on the type of insolvency proceeding that is being undertaken:

    - A corporate voluntary arrangement requires a report on the progress and prospects for the full implementation of the voluntary arrangement at least once every 12 months.

    - An administration requires a statement, setting out proposals for achieving the purpose of the administration, to be filed before the end of eight weeks after the company enters administration. Any revisions to these proposals following a creditors' meeting must also be filed.

  - A receivership requires a report on the action being taken by the administrative receiver (including a summary of any 'statement of affairs') to be filed within three months of appointment.
  - A voluntary liquidation requires a statement of affairs to be sent to Companies House within five business days of the creditors meeting and then liquidator's reports must be filed every 12 months thereafter.
  - Where a court orders a compulsory liquidation a liquidator may be appointed in place of the Official Receiver.
- Reporting to the Insolvency Service by an appointed insolvency practitioner on the conduct of the directors of the company who were in office in the last three years of the company's trading.

Recommendation 2: Clarifying the purposes of the going concern assessment and disclosure process

The Panel's preliminary analysis

67. In its preliminary report, the Panel discussed an expectation gap in connection with going concern reporting that was mentioned by a significant number of respondents to the Call for Evidence. The Panel concluded from the comments received that there is a risk that there is not a sufficiently common understanding, in relation to going concern assessments, about the going concern threshold[11] or the degree of conviction with which a going concern statement is required to be made or about the purpose(s) for which the assessment is made.

68. The Panel identified two purposes in making a going concern assessment. The first is to conclude whether the going concern basis of accounting is appropriate for the financial statements. The second is to provide information to stakeholders about the economic and financial viability of the entity and about the directors' stewardship and governance of the entity in that respect. The appropriate threshold and necessary degree of conviction depend on the purpose of the assessment.

69. Although these purpose(s) are not explicitly referred to in relation to the going concern assessment required by the accounting standards or that required by the Code and Listing Rules, the Panel concluded that both of these purposes underlie each of these requirements.

70. The respondents to the Call for Evidence who raised the going concern expectation gap had suggested a variety of reasons why it existed. In general, they suggested differences in perceptions about the threshold/boundary between a going and a gone concern by reference to which the directors and auditors judge whether there are material uncertainties that should be disclosed. Some think this should only be when the entity is very close to collapse or failure (i.e. the same threshold used to determine whether the 'break-up' or 'liquidation' basis of accounting should be used), whilst others think an entity is not a going concern unless there is a virtual guarantee that the entity will not fail or collapse. There is a significant difference in the level of conviction that the entity will not collapse or fail in each case. There is also no specific indication of the purpose(s) of the going concern uncertainty disclosures in the accounting standards that might assist directors and auditors in deciding where the boundary is intended to be on this spectrum.

71. These are largely matters of clarity as to purpose and of definition. The Panel's preliminary Recommendation 2 therefore called on the FRC to review and harmonise the language used and to clarify these matters.

[11] The criteria by which to judge whether an entity is or is not a going concern

Feedback from respondents

72. There was strong support for this recommendation, with twenty (6U; 7C; 7A) respondents agreeing in principle and four (2C; 2A) disagreeing.

73. Of the six respondents (1U; 3C; 1A) that neither agreed nor disagreed, two commented in this context. One (1C – financial services industry body) commented that the binary decision as to the appropriateness of the going concern basis of accounting should be preserved, that going concern disclosures should be balanced and in keeping with financial reporting objectives and that the Panel's objectives could be achieved through guidance on disclosures without altering the basis of assessment. The other (1MP) agreed that there is an expectation gap that needs to be addressed.

74. Of those who disagreed:

- one (1C) argued that the going concern basis of accounting is the only purpose of the assessment and that this is a matter of fact;
- one (1C) argued that the current framework worked well and that no change was necessary;
- two (2A) argued that the requirements for assessing the basis of accounting do not need to be changed and that the main area for the Panel's focus should be the forward looking disclosures.

75. One of these (1A) also argued that the UK accounting standards should not diverge from IFRS in relation to going concern. They noted that there are a number of overlapping requirements in the accounting standards, Company Law and the Code and Listing Rules – relating to the basis of accounting, material uncertainties and narrative disclosures – and suggested that these should be made more cohesive. This could be achieved without changing the accounting standards or Company Law requirements.

76. They also suggested that further consideration be given to the relationship between the material uncertainty and narrative disclosures, pointing out that the former must be included in the financial statements to meet the true and fair view requirement.

77. This respondent also highlighted what they considered to be an inconsistency between the FRC guidance on going concern assessments and ESMA's guidance on working capital statements which appears to require a high level of conviction ('little risk that the basis of such a statement is subsequently called into question') and is said in ESMA's guidance on working capital to be similar to the approach taken regarding going concern in relation to the financial statements. The FRC may wish to discuss this further with ESMA.

78. Many of those who agreed broadly with the recommendation also provided comments. The key themes that emerge from these comments are as follows:

- Some (mainly members of the Accounting profession) suggested that changes to accounting standards should be made only (or primarily) through influencing the international standards and divergence of UK standards should be avoided – gold-plating could put UK businesses at a disadvantage;

- A significant number of respondents (1U; 3C; 2A) urged the Panel not to lose the two separate purposes in any harmonisation of the language. One respondent (1C – internal audit) suggested that this may need to be reflected in two related but distinct assessment 'processes', one periodic and one on-going. Another (1A) suggested that the narrative disclosures should be kept as a separate layer to the information provided in the financial statements in connection with the going concern basis of accounting.

- One respondent (1A) took the view that the Panel's recommendations could be taken a stage further, breaking the link completely between the disclosures related to the basis of accounting (an assessment at a point in time) and the forward looking disclosures about the entity's ability to continue as a going concern. This respondent suggested that this would involve removing the material uncertainty disclosures from the accounting standards and embedding them in a standard on narrative reporting outside the financial statements.

- With regard to the language of the going concern statement, a number of respondents commented that they were comfortable with the directors making a statement that the entity 'is a going concern' as long as the directors also explained how they had arrived at this conclusion. They suggested that this is already required, in effect, by the Code provision reference to 'with supporting assumptions and qualifications as necessary'. Others said they wanted the language to be more nuanced, that fixed definitions can be too simple for the complexity of modern business. One (1U) suggested the that directors and auditors might alternatively make a statement about the going concern along the following lines:

  > *… that in their opinion the board was sufficiently cognisant of the risks to going concern being faced by the company and that there was a reasonable likelihood of the actions being taken in light of those risks allowing the company … to continue as a going concern ... [ie to meet its liabilities as they fall due in the next year from the date of reporting and have assets greater than liabilities over a reasonable (specified) period]*

The Panel's final considerations and recommendations

79. A comparison of the requirements of the international and UK accounting and auditing standards[12], the Listing Rules and the Code[13] and Company Law[14] suggests the following:

[12] The relevant international accounting standard is IAS 1, with some explanation in the IFRS Conceptual Framework, the relevant UK accounting standard is FRS 18, with some additional explanations in the ASB's Statement of Principles for Financial Reporting, the relevant international auditing standard is ISA 570 and the relevant UK auditing standard is ISA (UK & Ireland) 570 which is based on ISA 570 with some additional requirements and application material.

Criteria for when the going concern basis of accounting is or is not appropriate

80. The criteria for <u>not</u> using the going concern basis of accounting set out in each of these sources are broadly consistent. Each of IAS 1[15], FRS 18[16], ISA (UK & Ireland) 570[17] and the Guidance for Directors[18] makes clear that unless the entity's management intends to instigate, or cannot realistically avoid, the liquidation of the entity, the going concern basis of accounting is appropriate. The Companies Act requirement[14] is considered to be consistent with the requirements of FRS 18.

81. Under these criteria, use of the going concern basis of accounting does not require or imply a high degree of certainty that the entity will in fact avoid liquidation and that it will not cease trading. The going concern basis of accounting will, in effect, always be used unless liquidation is in process or imminent, conditions that are in fact rare. The Panel believes that this is the appropriate approach. The Panel also notes that these criteria are in fact criteria for when the 'break-up' or 'liquidation' basis of accounting1 is appropriate.

Definition of a going concern

82. None of the above sources contains a specific definition of what constitutes a 'going concern' but the term is described or referred to in each of them (other than in Company Law). First, they describe the circumstances in which the going concern basis of accounting would not be appropriate. The absence of these conditions is a necessary but not sufficient condition for a going concern. The various references to the term 'going concern' include, for example, the following additional insights:

UK accounting standards[19]	International accounting standards[20]	UK and international auditing standards[21]
'the entity [is a going concern if it] is to continue in operational existence for the foreseeable future'	'a going concern … will continue in operation for the foreseeable future … [and] … has neither the intention nor the need to liquidate or curtail materially the scale of its operations'	a going concern 'is viewed as continuing in business for the foreseeable future [and it is assumed] that the entity will be able to realize its assets and discharge its liabilities in the normal course of business'

13 The Listing Rules and the Code each require the directors of companies within their scope to include in their annual report a statement that the business is a going concern, together with supporting assumptions or qualifications as necessary – each refers to applicable guidance in the Guidance for Directors

14 The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008, Schedule 1, Part 2, Section A, paragraphs 10 to 15 requires the amounts included in a company's accounts to be determined in accordance with the principle that the company is presumed to be carrying on business as a going concern unless there are special reasons for departing from that principle.

15 IAS 1, paragraph 25 – 'An entity shall prepare financial statements on a going concern basis unless management either intends to liquidate the entity or to cease trading or has no realistic alternative but to do so.'

16 FRS 18, paragraph 21 – 'An entity should prepare its financial statements on a going concern basis, unless (a) the entity is being liquidated or has ceased trading, or (b) the directors have no realistic alternative but to liquidate the entity or to cease trading …'

17 ISA (UK & Ireland) 570, paragraph 2 – 'General purpose financial statements are prepared on a going concern basis, unless management either intends to liquidate the entity or to cease operations, or has no realistic alternative but to do so.'

18 Guidance for Directors, paragraph 14 – '… going concern basis … the company has no realistic alternative but to cease trading or go into liquidation or the directors intend to cease trading or place the company into liquidation.'

19 The Statement of Principles, paragraph 3.6; FRS 18, paragraph 22

20 The IFRS Conceptual Framework, paragraph 4.1

21 ISA (UK & Ireland) 570 and ISA 570, paragraph 2

83. Each refers to the continued operational existence of the entity. The auditing standards add that the entity expects to realise its assets and discharge its liabilities in the normal course of business. The international accounting standard adds that the entity should also not need to curtail materially the scale of its operations.

84. The application material to the auditing standards[22] also provides further insight into what is or is not a going concern, through the listed examples of 'events or conditions that, individually or collectively, may cast significant doubt on the entity's ability to continue as a going concern'. These include many of the symptoms of economic or financial distress discussed in Appendix 4 to the Preliminary Report[23].

85. In taking this forward, the FRC may wish to consider the extent to which the intent to pursue, or the absence of realistic alternatives to the onset of, the following conditions should be taken to indicate that an entity is not a going concern:

- The discontinuance, or material curtailment of the scale, of the operations of the business; or
- The inability to make new investments essential to sustain the business; or
- The realisation of the entity's assets or the discharge of its liabilities outside the ordinary course of its business operations including, in the extreme, through the liquidation of the business as a whole; or
- The maintenance of equity or debt funding outside its contractual terms; or
- The pursuit of new funding outside the ordinary course of the financial adaptability plans of the business (eg an emergency rights issue).

86. Some of these factors are referred to in each of the sources, but none includes all of them. Accordingly, there is considerable scope for differing interpretations about what constitutes a going concern. A clear and consistent definition internationally and across the accounting, auditing, governance and Company Law requirements would be an important foundation stone in ensuring consistent interpretations as to what constitutes a material uncertainty about the going concern status of an entity that should be disclosed.

87. The Panel believes that there would be considerable benefit in the FRC engaging in discussion with other national and international accounting and auditing standard setters and the European Commission[24], about what constitutes a going concern.

[22] See ISA (UK & Ireland) 570, paragraph A2
[23] See Appendix 4 to the Preliminary Report, paragraphs 28 to 55
[24] The European Commission Proposal for a Regulation of the European Parliament and of the Council on specific requirements regarding statutory audit of public-interest entities includes a number of requirements for auditors in relation to the going concern status of the audited entity, including at Article 22 (l) to " provide a statement on the situation of the audited entity or, in case of the statutory audit of consolidated financial statements, of the parent undertaking and the group, especially an assessment of the entity's or the parent undertaking's and group's ability to meet its/their obligation in the foreseeable future and therefore continue as a going concern."

88. The Panel also considers that, with a clearer definition of what constitutes a going concern, there should be no need to modify the wording of the Code requirement to state that the entity is a going concern and accordingly has modified Recommendation 2 in this respect.

The purposes of the going concern assessment

89. The Panel believes that there are two essential purposes of the going concern assessment that the directors undertake in order to meet the requirements of the accounting standards, the Code and the Listing Rules:

90. At the point in time when the financial statements are being drawn up:

- To determine whether the financial statements give a true and fair view and in particular:
    - To determine whether a break-up or liquidation basis of accounting, rather than the going concern basis of accounting, should be adopted in the financial statements and, if so, to provide related disclosures about the basis of accounting adopted; and
    - To evaluate whether there are material uncertainties about whether the entity is a going concern that should be disclosed in the financial statements.

91. On a continuing basis:

- To evaluate and report on the effectiveness of the directors' governance and stewardship of the going concern status of the entity.

92. The approach of the Guidance for Directors has been to bring together the requirements of company law, accounting and auditing standards, the Code and the Listing Rules. This approach has been highly appreciated by commentators, but bringing this material together may have conflated the different purposes of the going concern assessment. The Panel believes that the Guidance for Directors should clearly identify each of the above purposes and explain how they should articulate with each other, both in the assessment process and in the financial statement and narrative disclosures made by the entity.

Governance and stewardship of the going concern status of the entity

93. The Panel believes that consideration by the directors of the potential impact on the entity's going concern status, of the future risks and uncertainties that the entity is taking and facing, facilitates the directors' understanding of the potential impact on their ability to sustain the entity's business model, to meet its liabilities as they fall due and to maintain its prospects for future success.

94. If the explanation of a company's business model, strategy and principal risks in the narrative reporting is linked to the directors' insights in relation to considerations arising from their going concern assessment, this would also facilitate shareholders' (and other

stakeholders') understanding of the potential impact of these risks and uncertainties on the future going concern status of the entity, provided through the eyes of management, and would enhance their understanding of the directors' stewardship of these matters and their ability to engage about them.

95. This consideration, of the impact on the entity's going concern status of the risks and uncertainties the entity is taking and facing, should be the foundation of the going concern assessment undertaken by the directors and is best performed by integrating this consideration into the normal business planning and risk management processes the directors undertake.

Break-up or liquidation basis of accounting

96. The threshold of distress required in order to depart from the going concern basis of accounting and to adopt the break-up or liquidation basis of accounting is a level of distress that is both very high and very imminent. As it is a rare condition, for the vast majority of entities the conclusion will be evident from a relatively high level consideration of the imminent risks to the entity's going concern status.

Material uncertainties about the going concern status of the entity

97. The Panel believes that clarity is needed that the required disclosure in the financial statements of material uncertainties about the going concern status of an entity is not intended to signal when there are significant doubts about whether the liquidation basis of accounting should be adopted – this should broadly be self-evident at the date of the assessment. Rather, the Panel believes it is intended to signal when there are known reasons to doubt the entity's ability to remain a going concern for the foreseeable future, due to risk factors of such potential magnitude and likelihood of occurrence that information about them would affect the economic decisions of shareholders and other stakeholders.

98. The description of a material uncertainty as "a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern [for the foreseeable future]" is far from clear and open to considerable interpretation. The FRC might consider whether clarity would be aided by formulating a definition of what constitutes a going concern (see above).

99. Consideration might also be given to whether the juxtaposition of the terms 'material uncertainty' and 'significant doubt' is meaningful. Both terms indicate uncertainty – the first about the existence of causative events or conditions and the second about the effect of those events or conditions. The phrase also includes three qualifying terms: what is a 'material' uncertainty, what is 'significant' doubt and how strong a connection does the term 'may indicate' require between cause and effect? The FRC may wish to consider whether a simpler phrase such as 'a material uncertainty about whether the entity will

continue to be a going concern [for the foreseeable future]' would suffice if what constitutes a going concern and the term 'material' were each defined.

100. Although neither materiality nor significance is addressed further in the accounting standards, a material uncertainty is described in the auditing standards[25]. Taking this approach, materiality is considered by reference to the usefulness of the information to the economic decisions of shareholders and other stakeholders.

The threshold for material uncertainty disclosure

101. In the Preliminary Report, the Panel discussed some behaviours identified by respondents that were thought to result from the requirement to disclose material uncertainties and to be mutually reinforcing:

- Reluctance on the part of directors to make disclosures about significant doubts, even where there is a plan in place which it is thought will enable the company to recover, lest this further damage the business (this reluctance may reduce the frequency of such disclosures being made).

- Stakeholders' reaction to a (relatively infrequent) signal of significant doubt about the ability of the company to continue as a going concern being to withdraw support and credit or to sell shares.

102. These comments promoted the idea that disclosing doubts about the entity's ability to continue as a going concern signifies that the company is on the brink of collapse and becomes a self-fulfilling prophecy of failure. The result of research carried out by the Panel, as set out in Appendix 4 of the Preliminary Report, suggested that this is not actually the case. Out of a total of 48 companies reporting significant doubts, only two went into administration or liquidation.

103. Nonetheless, the Panel accepts that there is a risk of self-fulfilling prophecy that may result from the requirement to disclose material uncertainties. The Panel considers that this risk should be mitigated if such disclosure is given in the context of enhanced on-going narrative disclosure that appropriately identifies the risks to the entity's going concern status and how these are being addressed. Such disclosures should provide an understanding of the development of factors relevant to those risks so that, if they were to fall in, this should be less of a surprise to shareholders and other stakeholders.

104. If given in the context of such disclosures, the Panel believes that the material uncertainty disclosure should be an early warning signal that one or more of the risks that the entity will not remain a going concern for the foreseeable future has been heightened to the point where knowledge of that fact would be material to users of the financial statements. The

[25] ISA (UK&I) 570, paragraph 17 – A material uncertainty exists when the magnitude of its potential impact and likelihood of occurrence is such that, in the auditor's judgment, appropriate disclosure of the nature and implications of the uncertainty is necessary for: (a) in the case of a fair presentation financial reporting framework, the fair presentation of the financial statements, or (b) in the case of a compliance framework, the financial statements not to be misleading.

FRC may also wish to consider at what level of probability such knowledge would become material to users.

The foreseeable future

105. The future period over which the directors' assessment is made is an important element of the disclosure requirements because this, in part, determines the extent to which the directors actively look for material uncertainties. Again, the various sources are not wholly consistent in addressing this. However, there is usually a minimum period identified and a general requirement to consider all 'available information'.

106. One difference is that the minimum period referred to varies (twelve months from date of approval of the financial statements is referred to in FRS 18 and the UK auditing standards; twelve months from the end of the reporting period is referred to in the international accounting and auditing standards[26]). The Panel believes that a period of twelve months from the date of approval is more appropriate, as it reflects the period to the end of the next cycle for annual reporting, and that international harmonisation on this approach should be encouraged.

107. The Panel also supports the continued emphasis on the consideration of all information available at the date of the assessment. This would be reinforced by making the underlying focus of the assessment the directors' governance and stewardship of the going concern status of the entity as it would encourage appropriate consideration to be given to the risks to the entity's going concern status, whenever they might unfold. The Panel also believes that this approach would facilitate the longer term and more qualitative emphasis on solvency risks and the shorter term and more quantitative emphasis on liquidity risks referred to in Recommendation 3.

Taking these matters forward

108. In developing the final recommendation in this area, the Panel recognised the concerns that a good number of respondents raised that the FRC should seek to take the international community with it rather than making changes to UK accounting and auditing standards and then seeking to influence the international community to adopt similar amendments. The final recommendation is therefore now for the FRC ideally to seek agreement on a common understanding of these matters internationally and to make amendments to the UK standards and guidance, if possible in line with this.

[26] ISA 570, paragraph 13 requires the auditor to cover the same period as management is required to cover by the applicable financial reporting framework, or by law or regulation if longer. If this period is less than twelve months from the reporting date, the auditor is required to request management to extend its assessment period to at least this long and to consider the implications for its report if management is unwilling to do so (paragraph 22).

Recommendation 3: Reviewing the Guidance for Directors to include appropriate focus in particular areas

109. The Panel's Preliminary Report reiterated the importance of the directors' assessment of going concern as a fundamental aspect of the directors' stewardship of the entity and as an integral part of managing the business. It recommended that this assessment should incorporate an appropriate focus on solvency[27] as well as liquidity[28] risks and should be more qualitative and longer term in outlook in relation to solvency risks and more quantitative and shorter term in outlook for liquidity risks.

110. Consideration of solvency risks should include risks to the business model or capital adequacy that could threaten the entity's survival over a period that has regard to the likely evolution of those risks and the outlook for the economy and the business in light of past cycles of economic and business behaviour. Stress tests should be undertaken for both solvency and liquidity risks with an appropriately prudent mindset and should take into consideration the potential impact of those risks on all stakeholders, bearing in mind the directors' responsibilities under the Companies Act 2006.

111. There was strong support overall for these recommendations with 21 respondents (6U; 1MP; 7C; 7A) expressing support, 4 respondents (2C; 2A) disagreeing and five respondents (1U; 3C; 1A) neither specifically supporting nor disagreeing with this recommendation.

We agree that it is important for directors to consider the risk of solvency and matters of capital.

Corporate respondent

We are supportive of this recommendation. We believe that some companies are already making their assessments on this basis and such a step would help to spread this best practice.

Accountancy profession respondent

112. There were many comments from those who supported the recommendations:

<u>The focus on solvency</u>

113. Some asked what the Panel considered to be the <u>right</u> focus on solvency. The Panel had observed from the responses to the call for evidence that outside the financial services sector there was little or no focus on solvency in the going concern assessment. Solvency is

[27] Solvency is the entity's ability to meet its liabilities in full. This involves managing the sufficiency of its capital so that it has an appropriate excess of assets over liabilities (at least in the long run). Additionally, in order to have a realistic prospect of continuing to be solvent, the entity must develop and maintain an economic (business) model which is capable of delivering over time a continuing economic return (at or above the cost of capital) for its providers of capital. Solvency is therefore about the viability of the business model and the maintenance of its capital.

[28] Liquidity is concerned with the entity's ability to liquidate its assets (and/or to generate cash profits or to access new sources of short term funds) at the velocity needed to meet its liabilities as they fall due. Liquidity is therefore more relevant to the short term survival of the entity.

about the viability of the business model and the maintenance of the entity's capital – factors that are relevant both to equity investors and to those providing debt finance.

114. The value of looking at the longer term and qualitative aspects of the impact of solvency risks comes through highlighting those areas where strategic challenges to the business might first arise. The Panel recognises that it may be difficult to assess these risks quantitatively and there will be increased uncertainty attached to conclusions about their impact. Nonetheless, they remain valuable. The Panel considers that a belief in ultimate solvency underpins liquidity for all businesses and that solely focusing on liquidity risks is therefore inappropriate.

115. Others noted that solvency assessments may be particularly difficult when the entity's recorded assets are less than its recorded liabilities and when the entity's assets include significant intangibles. Other comments included that the focus on solvency should be included in IAS 1, that the immediate problem is usually cash flows or facilities rather than underlying solvency, that auditors are well placed to comment on the business model and that other risks should be considered too (including the entity's credit rating, risks in the supply chain and political risks).

Period of assessment and economic and business cycles

116. Comments (mainly from Corporate and Accountancy Profession respondents) included some questions about how to interpret the relevance of business cycles and the economic cycle to the assessment of going concern. A number emphasised the importance of the specified period (of twelve months), as part of the definition of the foreseeable future that underpins what constitutes a going concern, and supported its retention. Others noted that the longer term the focus of the assessment, the greater would be the uncertainty, the less meaningful would be the outcome of the assessment and the more unreasonable it would be to expect the directors to conclude about the entity's ability to continue as a going concern.

117. The Panel was not seeking to change the primary focus of the assessment on the entity's ability to continue as a going concern for the foreseeable future and, in that context, on the entity's ability to meet its liabilities and to continue in operation for at least the next twelve months. However, the Panel recognised that the definition of the foreseeable future already rightly focused on the need to consider all available information about the future. The Panel believes that, although it is difficult to predict with certainty the future evolution (in terms of amplitude and timing) of the general economic cycle or the relationship of the entity's likely business success to those cycles, it is nonetheless appropriate in considering the future to recognise and plan for changes that may result from a continuation of observed past cyclicality.

Stress tests

118. There were a number of comments that suggested that, whilst stress tests are important, they should not be prescribed in detail – they should be entity specific and their value depends heavily on the quality of the parameters tested. The Panel agrees that prescribed stress tests are inappropriate in the accounting standards and Code, as they may draw directors' attention away from more appropriate tests. Nonetheless, stress tests prescribed by a regulator may be an important element of those undertaken by an entity.

The relevance of Section 172 Companies Act 2006

119. A number of respondents commented on this, with some questioning how the directors should relate their responsibilities under this provision to their going concern assessment and others suggesting that the Panel's comments in this area could be broadened to fully reflect the directors' responsibilities. Some also pointed out that public interest concerns may also be relevant to the entity where a regulator effectively imposes regulations arising from them on the entity.

120. The Panel was not suggesting that the duties of the directors set out in Section 172 are the only responsibilities or duties of the directors. The Panel agrees that other duties and responsibilities may also be relevant. However, this section defines the directors' duty to promote the success of the entity and factors they should have regard to in doing so. The Panel believes it is important, in considering the risks to the future success of the entity, that the directors should have regard to their likely behaviour in promoting its success and responding to those risks.

121. Those who did not agree with this recommendation cited as reasons that the current guidance was satisfactory (2C; 1A) or that twelve months was preferable to any longer period, that the current emphasis on liquidity was appropriate and that stress tests could be too difficult in some circumstances (1A).

122. A number of specific suggestions were made by commentators that the Panel agrees should be considered by the FRC for inclusion in newly developed or amended guidance during their implementation of this recommendation:

- In assessing going concern, management should also consider the credit rating of the company, supply chain risks and political risks as these can impact on the continuing profitability of the entity and the availability of funds to borrow and their cost.
- It may be appropriate to include reference to going concern risks and the Guidance for Directors in the FRC's document on Internal Control (the Turnbull Guidance), when this document is updated later in 2012/13.

- The Guidance for Directors could address the practical difference in requirements for annual corporate reporting from guidance in relation to working capital statements, where the level of certainty required is greater.

Recommendation 4: Integrating going concern reporting with the ECS proposals

123. The Panel made this recommendation to enable users of corporate reports to better understand the robustness of the going concern assessment process and how the directors arrived at their assessment, as well as to support appropriate business behaviours as discussed under Question 1 above. Integrating going concern reporting with the ECS proposals should ensure that the directors reflect their assessment of and disclosures about the entity's going concern status as an integral part of their discussion of strategy and principal risks rather than solely as part of the outcome of an accounting assessment. Reporting about the going concern status of the entity is therefore always provided, rather than only when there are heightened risks.

124. This recommendation received support from 21 of the respondents (6U; 1MP; 5C; 9A), with 6 respondents disagreeing (5C; 1A) and 3 respondents (1U; 2C) neither specifically supporting nor disagreeing with the recommendation.

125. There was strong support from commentators for regular and more nuanced disclosure in narrative reporting, compared to the current more binary approach to reporting on going concern in the financial statements. The moment when a company moves from being a 'going concern' to a 'gone concern' is dependent on a variety of interrelated factors and it is therefore important to articulate the assumptions, caveats and sensitivities associated with the going concern status of the entity well before significant doubts about the ability of the entity to continue as a going concern emerge.

> *Moving from a binary reporting regime to one which promotes a more balanced discussion and consideration of the risks and mitigating actions reduces the risk of cautious going concern disclosure becoming a self-fulfilling prophecy.*
>
> *Accountancy profession respondent*

126. Commentators suggested that advantages that should result from the recommended approach include the following:

- Better business model reporting.
- If the directors have to explain how they have assessed risks to the business model (including solvency and capital adequacy), this might encourage them to place greater emphasis in their disclosures on the principal risks, rather than providing a much longer list of all risks.

> *Any disclosure of how boards arrived at their conclusion should be accompanied by a clear description of the risks and their significance, together with the sensitivity of any conclusions. This would assist users in assessing the robustness of the process.*
>
> *Investor representative respondent*

- Clear disclosure of how the directors arrived at the conclusion that the business is a going concern will assist the users in assessing the robustness of the process and its conclusion.

- Understanding the key vulnerabilities of the business during periods of 'business as usual' will support stakeholders in taking a considered decision when conditions deteriorate:

  … better, earlier information means that when longer term risks start to crystallise as short term issues, then investors and others are not taken by surprise; this ought to produce an environment in which directors are able to tackle the issues without their problems being compounded by sudden actions from investors and others.

  Accountancy profession respondent

- More open disclosures in relation to going concern from all companies may assist in addressing concerns held by many that disclosure about going concern issues will trigger a self-fulfilling prophecy.

127. However, some commentators feared that the recommended changes in disclosures could have a detrimental effect on companies, particularly in the first year of reporting, as an inappropriate market reaction to clearer disclosure of the risks and uncertainties associated with going concern may trigger the demise of healthy companies. The Panel notes that two commentators suggested that the Financial Reporting Lab might be an appropriate place where new approaches to narrative reporting such as this could be trialled.

128. A number of commentators expressed some concerns that companies operating in international markets may be disadvantaged when compared with non-UK companies that are only required to provide going concern disclosures when there are material uncertainties. The Panel notes that international discussion of these matters is beginning to develop and encourages the FRC to continue engaging in those discussions.

129. Some indicated that a number of companies already provide a more contextual analysis of the risks to the entity's going concern status in the annual report. Whilst the Panel recognises that this is so, the requirement of the Listing Rules to provide supporting assumptions or qualifications to the going concern statement where necessary is implemented in a variety of different ways.

  We accept that in some cases disclosure is not as expansive or clear as it should be to assist stakeholders in their understanding of how the directors reach their conclusions about going concern. We would therefore welcome further guidance for directors from the FRC in this area.

  Accountancy profession respondent

130. The Panel recognises that there has been improvement in this area since the Guidance for Directors was published, as was reported on by Deloitte in a recent report on corporate reporting practices by UK listed companies[29]. The Panel believes that further improvement is possible, through better disclosures of supporting assumptions and qualifications and better integration of the going concern statements with those other disclosures that have some relevance to going concern. For example, detailed disclosures on debt and borrowing facilities and treasury risk management are already required, but are included in notes to the accounts and there may be no reference to these disclosures in the information provided in relation to going concern in the narrative section of the annual report.

131. Many commented on the need to avoid boilerplate or standardised language, including in the audit committee report. Other comments suggested that there is a need to get the balance right between providing useful information for users and providing a clear gradation of signalling of the going concern status of the entity; consistent with the FRC's Cutting Clutter initiative, there is a need to avoid duplication about the going concern issue in different parts of the annual report –requiring the audit committee to address going concern separately might exacerbate this; and any information necessary to provide a true and fair view should be included in the financial statements not elsewhere in the annual report.

132. Many commentators highlighted the fact that disclosures in respect of going concern are currently spread throughout the annual report, despite the recommendation in the Guidance for Directors to bring a focus to the going concern disclosures in one place in the financial statements with cross-references to disclosures elsewhere in the financial statements and annual report if necessary.

> *… in our opinion going concern and liquidity risk disclosures by directors tend to be scattered through the other information in the front half of the annual report and financial statements with very little attempt made to provide any linkage between the liquidity risks and going concern.*
>
> *Accountancy profession respondent*

133. The Panel does not believe that requiring the audit committee to address its work on going concern in its separate report in the annual report, as envisaged under this recommendation, should result in duplication of disclosures between that report and other parts of the annual report. Duplication can be avoided by the use of cross references.

134. A number of commentators raised concerns that the recommended disclosures (particularly in relation to the going concern assessment process) could result in standardised wording which would not be beneficial.

[29] 'Gems and jetsam - Surveying annual reports' published October 2011. See http://www.deloitte.com/view/en_GB/uk/services/audit/9531b48367b13310VgnVCM1000001a56f00aRCRD.htm.

We therefore believe that guidance should not be overly prescriptive but should encourage honest, open disclosure both of qualitative information and also a quantitative description of sensitivity and other testing.

Investor respondent

We do not, however, underestimate the amount of work required to get workable guidance on this matter. It could all too easily lead to excessively long, boiler plate disclosures from which it would be difficult to judge what really mattered.

Investor representative respondent

135. The Panel's belief is that the illustration of the effectiveness of the process that is recommended as part of the audit committee report, cross-referring to more specific risk disclosures and what has been done in assessing these, will guard against this.

136. Integrating the discussion of the going concern status of the entity with the description of the business model required by the Code and the disclosure of principal risks required in the business review should enable the directors to explain the key vulnerabilities of the business in an entity specific manner, avoiding the use of standardised language. This should also not detract from the required focus on principal risks. The Panel believes that a material risk to the entity's going concern status is also likely to be a principal risk for the company.

137. The Panel's view is that the most appropriate place for the disclosures that are connected with the stewardship purpose of the going concern assessment is in the narrative reporting in the annual report, where links can be made between reporting on risks, financing and going concern. Clearly any such disclosure will need to be consistent with any new legal requirements for narrative reporting that arise from the BIS review, but the Panel believes it would be appropriate for the proposed strategic report to include the recommended integrated discussion of the company's business model, principal risks and assessment of the going concern status of the entity.

Recommendation 5: Moving towards an explicit statement in the auditor's report on the directors' going concern assessment process and its outcome

138. Currently the only explicit reference to going concern that is made in an auditor's report is where there is an emphasis of matter paragraph in respect of material uncertainties related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. In the Preliminary Report the Panel felt that the auditor's report should always include an explicit statement in connection with the stewardship purpose of the going concern assessment, and that statement should be clearly linked with the directors' disclosures about the robustness of their assessment process and its outcome.

139. The preliminary recommendation in this regard incorporated a suggestion that there would be no need to include an emphasis of matter paragraph where the directors had made adequate disclosures in this regard. The Panel felt that removing the emphasis of matter paragraph from the auditor's report would take away some of the 'stigma' attached to this reporting. However, the recommendation would not remove the reporting of such material uncertainties entirely from the annual report as they would still be required to be disclosed in the notes to the accounts under the accounting standards.

140. Among commentators there was support from 15 respondents (5U; 1MP; 5C; 4A) for this approach although many of these were guarded in their support:

> *We very much support that the APB needs to influence these to be revised in a way that facilitates the Panel's approach rather than one that prevents it (as retention of emphasis of matter for going concern would do). We agree that the UK should lead rather than follow.*
>
> *Accountancy profession respondent*

141. There was also support from 10 respondents (1U; 3C; 6A) for keeping the emphasis of matter paragraph in situations where the auditor considers that there are material uncertainties in relation to the entity's ability to continue as a going concern. Commentators felt that removing the auditor's duty to consider and report on this in their own right might weaken their voice in persuading the directors to make material uncertainty disclosures when appropriate:

> *… we are concerned [about] removing the option of an emphasis of matter paragraph in that this can be a useful disclosure and support retention of the current framework.*
>
> *Investor representative respondent*

> *… we do not support the proposal for the auditors to drop their emphasis of matter paragraphs. We believe that material uncertainty over the application of the going concern basis should be highlighted clearly to users of the reports. Furthermore, such a move would be contrary to other pressures on the auditors to say more about contentious issues.*

Accountancy profession respondent

142. Additionally some commentators felt that making such a change to the UK auditing standards absent a similar change being introduced internationally might be interpreted as a relative weakening of the UK standard and preferred engagement with the IAASB to seek to amend the international auditing standards if changing the going concern emphasis of matter requirement was considered appropriate. The Panel accepts that making a unilateral change to ISA (UK and Ireland) 570 on Going Concern would reduce international consistency and believes that the FRC should engage with the IAASB to promote further discussion about the issues arising from the Inquiry.

143. The Panel has reconsidered its recommendation in light of the comments received and concluded that it is not necessary to remove the emphasis of matter requirement for the auditor in order to achieve the objectives set out in the Preliminary Report. Accordingly, the Panel has amended Recommendation 5 in this respect.

144. Commentators generally supported the other aspect of this recommendation for the auditor to make a positive statement about the directors' disclosure on the robustness of the going concern assessment process and its outcome.

> *… we would support a fuller going concern statement in annual reports … The auditors could confirm that the assumptions and risks disclosed, overall, are a reasonable and balanced summary … and that nothing of significance has been omitted.*

Accountancy profession respondent

145. Implementation of such a revision to the auditor reporting model would require appropriate criteria to be developed for the evaluation of the disclosure provided by the directors on the robustness of the going concern assessment process and its outcome. Amendments to the Guidance for Directors should provide such criteria.

146. As for the wording of the additional reporting to be given by the auditor, two commentators suggested that this should be worded as a conclusion that the directors' assessment of going concern is reasonable (or that they have reasonable grounds for their conclusions). Another alternative suggested was for a confirmation that the assumptions and risks disclosed are a reasonable and balanced summary of the assessment. The Panel is concerned that the work required of the auditor in order to make the statement proposed should be in line with that envisaged under the ECS proposals and so continues to recommend that the auditor should report on the disclosures made by the directors. However, it suggests that the wording might be amended to make it more positive.

147. Changes to the auditor reporting standard ISA (UK and Ireland) 700 could be made unilaterally, as this standard does not directly follow the international equivalent.

148. However, the Panel notes that there is discussion developing internationally[30] about the auditor's report addressing the going concern status of the entity and believes that the FRC should continue to engage in those discussions in the context of taking forward this recommendation.

[30] In this connection, the Panel notes that EU proposals for a new regulation includes a requirement for the audit report of listed companies to include an assessment of the entity's ability to meet its obligations in the foreseeable future and therefore continue as a going concern. In the context of its project on auditor reporting, the IAASB is also considering the need for the auditor to always address the going concern status of the entity in the audit report, rather than just in the circumstances when an emphasis of matter paragraph is required.

Question 3: Should the scope of any final recommendations be applicable only to listed companies or also to other entities? If they should be applicable also to other entities, please indicate whether to all or only some types of other companies and entities and whether any adaptations should be made to the recommendations in doing so.

149. For a subject such as going concern which crosses the areas of accounting, corporate governance and auditing, implementation is made somewhat complex by the different structures of the three frameworks:

- Accounting standards in the UK have a three tier approach: IFRS for listed companies; UK GAAP for non-listed companies and other entities not eligible to follow the FRSSE; and the FRSSE for small companies and other entities which are eligible to follow it. However, the requirements in relation to going concern are broadly consistent across all three categories, so that making a change in one would inevitably raise questions about the need for changes in the others.

- Corporate Governance requirements only apply to listed companies through the operation of the Listing Rules.

- In the case of auditing standards, the going concern requirements apply to all audits.

150. As a result, the current requirements relating to going concern are similar for all companies, with the exception of making a going concern statement, which is only required for listed companies.

151. Of the 22 respondents (6U; 1MP; 6C; 9A) who responded to this question, the responses were varied:

Proposed scope	Number of respondents				
	U	M	C	A	Total
Listed companies only			1	3	4
Listed companies plus[31]	3		3	2	8
All companies, with proportionate disclosures	2		2	3	7
All companies	1	1		1	3

152. A number of commentators believed that it would be desirable to have broad consistency (with some specifically suggesting proportionate disclosures) of the going concern requirements across all entities, as the principles are not dependent on the type or size of the company and this approach would avoid inefficiency and confusion.

[31] There were a variety of suggestions for which companies should be added but these were generally either to add certain more complex or larger entities or a combination of both – suggestions included adding PIEs (recognising there may be different definitions of these), large private companies or publicly traded companies.

> *… going concern is the underlying assumption in all financial statements prepared in accordance with accounting standards. Therefore in principle any changes affecting going concern should be applied to all entities.*
>
> *We would prefer to see a consistent model and thought process applied to going concern regardless of the type and size of entity – the considerations of solvency and liquidity should apply to all.*
>
> *Accountancy profession respondents*

153. Others felt that the burden of work that is attached to the Panel's recommended improvements in corporate reporting may be excessive for some smaller non-listed entities; that there might not be the same benefits from the enhanced disclosures for stakeholders of such companies as for those of listed companies; and the longer timeframe over which such entities are required to publish their annual reports mean that going concern disclosures may not be so relevant. Such respondents either suggested restricting the enhanced disclosures to listed entities or to a combination of listed entities and some other types of entity[31].

154. Clearly some aspects of the framework, such as those which rely on Code requirements to have an audit committee in place, would not necessarily be transportable to companies that do not need to comply with these requirements. However, one commentator felt that going concern reporting beyond the listed sector could be improved and so widening the scope of the current requirements that apply only to listed companies (for example, the going concern statement by directors) and extending the enhanced reporting requirements recommended by the Panel would be beneficial.

> *… there is no similar requirement or mechanism for unlisted companies to make public disclosures about the current stresses being experienced by the company and about the management of those stresses outside the normal annual reporting process. Too often this means that unlisted companies do not pay attention to going concern risks during the period between audits and too much pressure is then placed on the disclosure in the financial statements and wording of the audit report included in the annual accounts because this is the first notice given of any issues with regard to going concern.*
>
> *Accountancy profession respondents*

155. Two commentators suggested that the three-tier approach in the Companies Act for the presentation of the business review could be a useful framework for setting the scope of requirements in relation to going concern disclosures. Another alternative suggestion was to leave it to regulators in specific sectors to decide whether an enhanced commentary and disclosure regime would be appropriate for their industry sector, in which case the listed company model proposed by the Panel might be useful and avoid the need to develop something new.

156. The Panel believes that where implementation of its recommendations can be integrated with the changes being introduced to implement the ECS proposals, this should be the mechanism followed in the first instance, in order that the number of changes experienced by business is kept to a minimum. The Panel therefore proposes that initially Recommendations 4 and 5 should be limited in scope to those companies that the ECS requirements are applied to. Implementation of these recommendations would be through amendment to the Guidance for Directors, the Guidance on Audit Committees and a number of the UK auditing standards.

157. Recommendations 2 and 3 can be implemented initially through amendments to the Guidance for Directors. The Guidance for Directors applies to all companies but only listed companies are specifically required to comply with it through the operation of Listing Rule 9.8.6R (3). In any case, the Guidance for Directors notes that directors of all companies should apply the guidance in a manner proportionate to the nature of their business. Companies that follow this guidance will therefore be entitled to take into consideration the nature of their governance arrangements, such as not having an audit committee, and to tailor their assessment and disclosures to their circumstances.

158. It will be for the FRC, in taking forward these proposals, to determine the most appropriate approach to, and timing of, any changes which may be necessary to reflect the clarifications and amendments set out in Recommendations 2 and 3 in the UK accounting and auditing standards and related guidance. The FRC may wish to first pursue international debate to seek agreement on the extent and nature of the need for the recommended clarifications and amendments of the Panel set out in Recommendations 2 and 3, in order to avoid unnecessary divergence from international standards.

159. The Panel believes that the Guidance for Directors provides an appropriate mechanism for implementing recommendations 2 and 3, as well as being indicative of best practice in relation to recommendations 4 and 5. There would be a need to liaise with the UKLA in updating the Guidance for Directors in order to maintain the reference to this guidance material in the Listing Rule.

160. There would also be a need for continuing liaison with BIS in order that the implementation of the changes to going concern reporting in Recommendations 4 and 5 is consistent with the outcome of their proposals for changes to the regime for narrative reporting. The Panel believes that further consideration should be given, in that context, to the extent to which it is desirable to apply Recommendations 4 and 5 to entities other than those to which the ECS proposals are applied.

Question 4: In relation to banks, do you have any comments on:

- **The suggestion that there should be a separate disclosure regime for banks and their auditors in relation to the going concern assessment?**
- **The merits of a separate financial reporting and auditing regime for banks?**

The going concern disclosure regime for banks

161. It was questions about the circumstances where banks failed shortly after their financial statements received unqualified audit opinions which led in part to the launch of the Sharman Inquiry. In its review of the evidence received the Panel did not find that the going concern assessment process was thought to be any different for a bank as compared with other entities. However, the preliminary report did recognise that the intensity of their solvency and liquidity risks is greater as a result of the combination of high gearing and the process of maturity transformation that the banks undertake.

162. In addition, there is a specific question about whether financial support provided to a bank by a Government or Central Bank should be disclosed in the financial statements of the bank. Failure to disclose such information could potentially lead to a false market in that bank's securities. Equally, untimely disclosure of such support could damage confidence in the bank and may cause wider damage to financial stability. Secrecy may therefore be desirable from a financial stability perspective. Nonetheless, it may be difficult to maintain secrecy, given that a number of players may have obligations to disclose the information or information from which the support may be deduced by the markets (including, in the case of the bank, in the annual report and the financial statements as well as under the Disclosure and Transparency Rules[32] and the Prospectus Rules[33] of the UKLA), despite the existence of some derogations[34, 36].

---

[32] What constitutes 'inside information' under the Disclosure and Transparency Rules of the UKLA is a matter of judgment but the receipt of emergency financial support by a bank from the Bank of England or the Government may well do so. Under those rules, inside information must be disclosed to the markets as soon as possible, subject to the limited ability to delay disclosure under those rules[34].

[33] Disclosure of the receipt of emergency financial support by a bank from the Bank of England or the Government may be required in order to comply with a number of requirements of the Prospectus Rules, subject to the limited ability to omit such information where so authorised by the FSA. Under PR 2.5.2, "The FSA may authorise the omission from a prospectus of any information, the inclusion of which would otherwise be required, on the ground (a) that its disclosure would be contrary to the public interest; (b) that its disclosure would be seriously detrimental to the issuer, provided that the omission would be unlikely to mislead the public with regard to any facts or circumstances which are essential for an informed assessment of the kind mentioned in section 87A(2) [of the Financial Services and Markets Act, 2000] [includes an assessment of the assets and liabilities, financial position, profits and losses, and prospects of the issuer and of any guarantor] …".

[34] For example, under DTR 2.5.5A R: "An issuer that is a firm may have a legitimate interest to delay disclosing information concerning the provision of liquidity support by the Bank of England or by another central bank." Consistent with the Market Abuse Directive, this is subject to the overriding obligation that the information must be kept confidential and the delay must not mislead. This rule was introduced into the DTR in response to the circumstances surrounding the run on Northern Rock – see FSA Consultation paper CP08/13 *Disclosure of liquidity support* published in July 2008 (http://www.fsa.gov.uk/pages/Library/Policy/CP/2008/08_13.shtml); consultation document Cm 7308 Financial stability and depositor protection: strengthening the framework published jointly by HM Treasury, the Financial Services Authority and the Bank of England in January 2008 (http://www.bankofengland.co.uk/publications/financialstabilityanddepositorprotection080130.pdf); and consultation

163. The Panel concluded that some difficult decisions may need to be made about the extent of disclosure of material uncertainties in annual reports and financial statements, both by banks and their auditors, to comply with the accounting standards, company law and Listing Rules[35]. It is for the banks and their auditors to determine whether such disclosure is required. As there are no specific derogations from these requirements to disclose significant going concern issues in the annual report, this is so even if the regulator desires secrecy in the interests of financial stability[36]. Similarly difficult decisions may be necessary to comply with the rules of the UKLA.

164. In forming their judgments on whether disclosure is required, banks (and their auditors in relation to disclosures in the annual report and financial statements) will consider, amongst other matters, the scale of the threat to the going concern status of the bank. While they will need to agree questions as to compliance with the disclosure requirements of the Disclosure and Transparency Rules and the Prospectus Rules with the UKLA, it is the Bank of England and the FSA (and will be the PRA) that have responsibility for interpreting the scale of the threat to going concern in the context of their financial stability and prudential supervision objectives and (if necessary with direction from the Chancellor and HM Treasury guarantees) for the appropriate public interest response to that threat – the bank and its auditors will therefore need to consult with them on these matters.

165. In the preliminary report, the Panel concluded that, if there was a desire for further derogations (in effect a special regime for going concern reporting in relation to banks), for example to allow the bank and the auditor not to make certain going concern material uncertainty disclosures, this would be a matter of public policy requiring a balance to be drawn between the public policy objectives of transparent financial reporting to shareholders on the one hand and financial stability on the other. Accordingly this was a matter that should be decided by Parliament or by the relevant EU legislative organs and would require changes to EU law as well as to UK laws and regulations.

166. Respondents who answered the first part of Question 4 about the suggestion that there should be a separate disclosure regime for banks and their auditors in relation to the going concern assessment had mixed views on the subject. Investors generally felt that secrecy about financial support did not benefit shareholders. However, the appropriate place for discussion about specific disclosures was between boards, auditors and regulators and this was likely to be improved now with new arrangements for dialogue between these parties.

---

document Cm 7436 Financial stability and depositor protection: further consultation published jointly by HM Treasury, the Financial Services Authority and the Bank of England in July 2008 (http://www.bankofengland.co.uk/publications/other/financialstability/financialstabilitydepositorprotection080701.pdf).

[35] Listing Rule 9.8.6 R (3) requires a statement by the directors that the business is a going concern, together with supporting assumptions or qualifications as necessary and Listing Rule 9.8.10 R (1) requires the auditors to review that statement before the annual report is published.

[36] In relation to disclosure of inside information (but not information required to be disclosed in the financial statements), the Proposal for a Regulation of the European Parliament and of the Council on insider dealing and market manipulation (market abuse), Article 12, paragraph 5 authorises a competent authority to permit delayed disclosure of inside information if the information is of systemic importance, the delay is in the public interest and confidentiality of the information can be ensured. See: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0651:FIN:EN:PDF

167. The Panel has given further thought to this matter and believes that it should not be necessary to have a separate going concern disclosure regime for banks. The context in which the Panel has come to this conclusion and the rationale for doing so are set out below.

168. The Panel believes that in taking forward the definition of a going concern, the FRC would need to consider making clear that liquidity support from central banks may be a normal funding source for a bank and that reliance on such support if reasonably assured, based on an assessment of the bank's ability to meet and continue to meet the conditions for its availability, does not mean that the bank is not a going concern or that material uncertainty disclosures or an emphasis of matter paragraph are required. The Panel considers that this is critical to its conclusion that it should not be necessary to have a separate going concern disclosure regime for banks.

Understanding the context in which we have drawn our conclusions

<u>Why banks are different – their business models intensify their going concern risks</u>

169. As set out in the Preliminary Report, the business model of banks is to perform a financial intermediation role, known as maturity transformation – on the whole, channelling collective funds obtained through shorter term borrowing into longer term loans and investments. This creates a maturity mismatch between the dates on which the bank's liabilities fall due for payment and the dates on which it can call for repayment of its assets. This makes banks' funding models inherently unstable.

170. Confidence in the bank's solvency is what sustains this business model in the face of such instability. Depositors and other lenders roll over their loans to the bank, or other lenders replace them, when they are confident that the bank will continue to be solvent and viable. On the other hand, fear about the future viability and solvency of the bank provokes expectations of delayed or non-repayment and precipitates withdrawal of loans by existing lenders and deters others from replacing them. Gearing, market-based funding models, potential off-balance sheet exposures and other complexities in their operating models may further exacerbate these fears.

171. Given that a bank has limited liquid resources compared to its liabilities, a run results from knowledge that its liquid assets will be insufficient to fund repayment to all lenders when due, exposing those who linger to increased risk of delayed repayment and a greater share of the risk that losses on the remaining assets will exceed capital. There is a rush to the exit at the first hint of going concern issues. A bank's business model cannot be sustained in these circumstances and it will fail. In the banking business, such failure can be infectious and rapidly spread to other banks.

172. The banking system provides a range of financial services (payment systems, savings accounts and credit), which oil the wheels of the economy. There is a significant public interest in preventing disruption to these services but there would also be a moral hazard

in protecting them at all costs. This might encourage irresponsible risk taking in the knowledge that society would protect them against the costs of failure. A balance has to be struck.

173. The Bank of England, amongst others, is responsible for protecting and enhancing the stability of the UK financial system. It works within a balanced framework set by law which recognises not only the importance of stability but also that the possibility of failure engenders market discipline. Where support can be justified, it is provided (if necessary, at cost to the public purse with HM Treasury approval) whilst seeking to avoid rewarding commercial failure.

174. Whereas protection from solvency issues resulting from poor commercial practice (such as weak lending models) cannot be justified, measured support to mitigate temporary system-wide or entity-specific liquidity shocks experienced by solvent and viable banks is a critical ingredient of the financial stability toolkit. When a bank is judged not to be solvent or viable, support is not justified, failure ensues and the objective is to minimise the impact of that failure on the financial system and the economy.

<u>Developments since the financial crisis</u>

175. Following the financial crisis, wide ranging reforms have been, and are still being, introduced that are relevant to the going concern assessment for banks. These include: David Walker's recommendation that FTSE 100 financial services companies should have a separate Risk Committee; more intense stress testing regimes (including the European Banking Authority tests); the new liquidity regime introduced by the FSA; the Basel III accord which proposes a number of changes, including to minimum capital requirements and liquidity requirements; a major overhaul of the Bank of England's liquidity insurance facilities; the introduction of individual bank Recovery and Resolution Plans; the proposed Proactive Intervention Framework; the introduction of the Special Resolution Regime; and the recommendations of the Independent Commission on Banking.

176. All of this has intensified the focus of directors' and supervisors' continuing assessment of the viability of banks' business models and their ability to respond effectively to liquidity and solvency shocks.

<u>Liquidity management and liquidity support</u>

177. The primary responsibility for the prudent management of a bank's liquidity risk lies with the bank's directors and the costs of poor management in this regard primarily lie with its shareholders. Banks hold liquid assets such as high quality assets that can be exchanged rapidly for money in liquid markets, or committed interbank loan facilities, as self-insurance against liquidity shocks.

178. However, the Bank of England also provides a range of liquidity insurance facilities for UK banks, which they may access subject to being judged as solvent and viable. Access is

designed not to undermine banks' responsibility prudently to manage their solvency and viability.

179. Access is also designed not to undermine the incentives for banks to manage their liquidity risk prudently in the market without seeking support from the Bank of England. Hence, an overarching condition of access is that the bank must be judged to be solvent and viable by the Bank of England, when it lends under the facility. In addition, borrowing from the Bank of England is conditional on the bank providing sufficient collateral. Sufficiency is judged not only against current value but also against the estimated risk of that value falling before the drawdown is due to be repaid. Haircuts are therefore required against current values to allow for this. Furthermore, pricing of these facilities is designed to incentivise prudent liquidity management.

180. The Bank of England's principal liquidity insurance facilities are part of the Bank's Sterling Monetary Framework, which is described in the 'Red Book'[37] and which covers the Bank of England operations in the sterling money markets that serve both its monetary stability and financial stability objectives.

181. Some of these are short term facilities that are used primarily for implementing monetary policy (eg operational standing facilities and short term repo operations). Drawings under these short term facilities can only be backed by a narrowly defined collateral set, eg high-quality sovereign debt.

182. Other facilities provide broader liquidity insurance to the financial system. The Indexed Long-term Repo facility offers individual banks the chance to bid for moderate amounts of liquidity in the form of central bank reserves for maturities of three and six months against a wider range of eligible collateral than for the short term facilities (additionally accepting liquid and high quality mortgage and corporate bonds). There are scheduled market-wide auctions of these loans, which are allocated to those banks at a clearing price. The recently introduced Extended Collateral Term Repo is a contingent facility which would similarly operate through market-wide auctions of central bank reserves. The range of collateral accepted is wider than for Indexed Long-term Repo operations (additionally including transferrable illiquid securitised loans and mortgages and own name securitisations, covered bonds and loans).

183. However, some facilities are designed to provide insurance primarily against entity-specific liquidity shocks. The Discount Window Facility is such a facility, available on-demand on a bilateral basis, rather than only when a market-wide operation is scheduled. It is designed to provide liquidity normally up to 30 days. It is intended to act as a bridge facility, only being advanced when there is a credible path to a point where access is no longer required. It is structured as a swap of lower liquidity assets for high liquidity gilts

[37] The most recent version of the Red Book can be found at: http://www.bankofengland.co.uk/markets/pages/sterlingoperations/redbook.aspx

which can be exchanged for money in the markets. The range of collateral accepted is the same as for the Extended Collateral Term Repo facility.

184. These are the principal, permanent liquidity insurance facilities offered by the Bank of England. They are in the Bank of England's published frameworks and are designed to be offered on (collateralised) terms that protect its capital.

185. Beyond this, there are some more exceptional ways in which a bank in crisis may receive support from the Bank of England or HM Treasury. Given that these may put the Bank of England's capital at risk they may be provided with a Government guarantee. Decisions involving public funds are the sole responsibility of the Chancellor and HM Treasury. The Financial Services Bill, currently passing through Parliament, proposes to clarify the way in which such support is provided and who is in charge of what, and when, in the course of future financial crisis management[38]. In addition to the published facilities described above, the following support may be provided:

- Support operations for the market as a whole to meet system-wide shocks;
- Support operations outside the published frameworks (referred to as ELA) to firms that are at risk but are judged to be solvent, either at the Bank of England's proposal and subject to Treasury authorisation or on terms other than proposed by the Bank of England, if so directed by the Chancellor;
- ELA to firms that are at risk and that are ***not judged*** by the Bank of England to be solvent and viable, if so directed by the Chancellor; and
- Special support operations for the financial system as a whole, going beyond the published frameworks, when so directed by the Chancellor

186. Similar to the Discount Window Facility, in addition to the need for the Bank of England to conclude that the entity is solvent and viable, the Bank of England would only make an advance without direction or guarantee when in their view there is a credible path to a point where access is no longer required. If the Chancellor directs the Bank of England to carry out a support operation, the Bank of England acts as agent of HM Treasury, setting up a special purpose vehicle to carry out the support operation. The SPV would be indemnified by HM Treasury.

[38] See: *A new approach to financial regulation: securing stability, protecting consumers*, presented to Parliament by the Chancellor of the Exchequer by Command of Her Majesty, January 2012 at: http://www.hm-treasury.gov.uk/d/fin_fs_bill_policy_document_jan2012.pdf (see especially Appendix E – MOU on crisis management)

Limiting systemic damage when banks fail

187. The Proactive Intervention Framework[39] is part of the PRA's proposed monitoring and mitigating of risks to the safety of individual firms and sets out how and when the PRA will escalate its engagement as risks increase. The Bank of England will have a statutory duty to notify HM Treasury when it considers there to be a material risk of circumstances arising in which public funds would be at risk. A bank experiencing difficulties would therefore be subject to intensified regulatory intervention by PRA, working closely with the Bank of England and HM Treasury when necessary.

188. This may lead to a wide range of actions being taken. It may prompt the bank to seek access to the Discount Window or ELA. Even if a bank isn't thought likely to survive as a going concern in its own right, it may be possible for normal supervisory intervention to promote a solution, such as acquisition by another bank, that will protect the financial system and depositors. However, in exceptional circumstances, normal supervisory tools may be inadequate. To deal with such situations, a permanent SRR was established under the Banking Act 2009.

189. A bank's entry into the SRR is triggered when the FSA (or PRA) judges that the bank is failing or is likely to fail the threshold conditions and that it is not reasonably likely that alternative action will be taken by the bank that would enable it to satisfy those conditions[40]. The threshold conditions, which must be met by a bank both upon authorisation and on an on-going basis, include amongst others that it has sufficient liquidity and capital resources.

190. In effect, these conditions mean that reliance on Government support or on other than ordinary market assistance by the Bank of England, without which the bank would, or would be likely to, fail to meet the FSA's threshold criteria – would normally result in the bank being referred to the SRR. Once referral is made, public disclosure is likely to be made within a relatively short period if resolution powers are used though this may not always be the case – for example, where Government support is provided and this stabilises the position for the time being.

191. The concept of 'ordinary market assistance' is judgmental. As explained in the *Special Resolution Regime: Code of Practice*[41], the Bank of England provides banks with a spectrum of

---

[39] See joint paper issued by the Bank of England and the FSA: The Bank of England, Prudential Regulation Authority – Our approach to banking supervision – May 2011: http://www.bankofengland.co.uk/publications/other/financialstability/uk_reg_framework/pra_approach.pdf

[40] The conditions under which such referral should occur is set out in the Banking Act 2009, Section 7, sub-sections (2) to (4):

(2) Condition 1 is that the bank is failing, or is likely to fail, to satisfy the threshold conditions (within the meaning of section 41(1) of the Financial Services and Markets Act 2000 (permission to carry on regulated activities)).

(3) Condition 2 is that, having regard to timing and other relevant circumstances, it is not reasonably likely that (ignoring the stabilisation powers) action will be taken by or in respect of the bank that will enable the bank to satisfy the threshold conditions.

(4) The FSA shall treat Conditions 1 and 2 as met if satisfied that they would be met but for financial assistance provided by—

(a) the Treasury, or

(b) the Bank of England (disregarding ordinary market assistance offered by the Bank on its usual terms).

[41] See http://www.hm-treasury.gov.uk/d/bankingact2009_code_of_practice.pdf

assistance in all types of different circumstances. Whether or not financial assistance from the Bank of England constitutes "ordinary market assistance... on its usual terms" will depend on a combination of factors, including the terms of the Bank's operation, the circumstances of the bank receiving liquidity from the Bank, and conditions in the relevant markets in which the firm was, or would otherwise be, seeking to access funding. Furthermore, these factors may vary during the period that any assistance is given.

192. Regulatory tools to address the problems once the SRR has been triggered fall into two categories, stabilisation tools and a new special insolvency regime for winding up banks (the *Bank Insolvency Procedure*).

Conclusions: the implications for bank going concern assessments and reporting

193. The key issue for banks is that in practice <u>any</u> signalling of material uncertainties about their going concern status may trigger a liquidity shock and potentially a run on the bank. Given the intensity of their gearing and maturity transformation, this may create a need to call on the Bank of England for support.

194. As explained above, the Bank of England aims to provide adequate liquidity facilities to the banking system that are responsive to system-wide issues. Where a bank envisages needing to avail itself of Bank of England liquidity insurance facilities in the face of systemic issues, the directors and auditors would need to satisfy themselves that those facilities will be accessible by the bank to a sufficient extent and over a sufficient time period to enable them to conclude that the entity will remain a going concern for the foreseeable future.

195. If they are able to draw that conclusion, they should be able to conclude that there is no material uncertainty that is required to be disclosed by the bank and no requirement for an emphasis of matter paragraph to be included in the audit report by the auditor. As described above, we note that in order to access liquidity from the Bank of England (absent a direction from the Chancellor and a Government indemnity to the Bank of England), a bank needs to be judged both solvent and viable by the Bank of England. Therefore, particular attention must be given by bank directors to ensuring that the bank is and will remain solvent and viable, through the cycle, if they are to assume that they can access Bank of England facilities.

196. This judgement is one for the directors alone. However, the directors and auditors should be in close dialogue with the Bank of England and the regulator in these circumstances. The Code of Practice for auditors and supervisors signals the importance of those channels of communication between auditors and supervisors being familiar and effective in both normal and troubled times.

197. The approach to the issue taken by the directors and auditors should articulate appropriately with the escalation of supervisory intervention under the Proactive Intervention Framework, that ultimately would result in the referral of the entity into the

SRR if it is considered that the bank is failing (or is likely to fail) to satisfy its 'threshold conditions' and it is not reasonably likely that alternative action will be taken that would enable it to meet those conditions. They should seek to understand the status of escalation, the factors giving rise to this and the actions being taken to address them. Whilst these matters may not be definitive in determining whether there is a material uncertainty, they should be taken into consideration.

198. Where access to the Bank of England's liquidity facilities and/or to ELA is envisaged, the directors and auditors should seek to understand the Bank of England's assessment of the solvency and viability of the bank and the credibility of the bank's plans to reach a point where access is no longer required. If the directors are unable to conclude that there is no material uncertainty that is required to be disclosed (or the auditors are unable to concur), the directors and auditors should seek to understand whether the FSA (or PRA) believes that the entity should be referred into the SRR and, if not, why not.

199. If the directors or auditors remain unable to conclude that there is not a material uncertainty, the directors may conclude that material uncertainty disclosures are required and/or the auditors may conclude that an emphasis of matter or qualified opinion is required. Where the underlying issue is system-wide, it is possible that other banks are drawing on those facilities and that disclosure of that reliance would not trigger adverse reactions from the market.

200. However, in these or in other circumstances, for example where a bank faces uncertainties as a result of entity-specific issues, either of these actions may be expected to result in a run on the bank and the expectation that such disclosures are to be made may in itself therefore lead to the conclusion that the proposed disclosure is sufficient grounds to trigger the bank being put into the SRR.

201. That such a situation may arise may, of course, be undesirable but it is a consequence of the fact that the directors and auditors are responsible for making their own judgments about the future solvency and viability of the bank and cannot simply defer to the judgment of the Bank of England or Ministers; the directors and auditors will need to reach and stand by their own judgments. It should also be emphasised that, whilst this situation remains a possibility, it is highly desirable that close dialogue between the various players should ensure that a consensus judgment is reached where possible.

202. Where a bank is, or envisages that it may be, reliant on Government or Bank of England support but the Bank of England is, or would be, unable to conclude that the entity is both solvent and viable, it seems likely that referral into the SRR will be triggered, either on the facts or because the directors or auditors of the bank conclude that disclosure is necessary and the expectation of that disclosure triggers the referral. In practice, subject to early public disclosure of the referral, disclosure by the directors or auditors may then become unnecessary or will be made in circumstances where the regulatory tools deployed to

address the cause of referral into the SRR will protect the bank from the normal consequences of such disclosure.

203. The Panel also believes that its recommendation to improve the disclosures in the narrative reporting provided in the annual report may, at least over time, make disclosures of liquidity sources and the risks attached to them normal practice, so that reliance on the Bank of England's permanent liquidity insurance facilities, and perhaps even ELA, will come to be seen, rightly, as a natural part of the banking system for solvent banks that provides financial stability. Whilst it signals liquidity stresses that need to be understood, it should not always ring alarm bells of impending failure.

A separate financial reporting and auditing regime for banks?

204. The Panel also asked about the merits of a separate financial reporting and auditing regime for banks in view of particular characteristics in relation to the uncertainties around asset values and the complexity of their operations and structures.

205. As a result of uncertainty around asset values, there are greater ranges of asset values which are possible for banking entities than for other entities and some investor commentators suggested that IFRS has enabled banks to be overly optimistic about their balance sheets. There was also some recognition amongst a small number of commentators that a consistent definition of capital and reserves could be useful.

206. However, most commentators thought that, as financial reporting and auditing standards have been developed in order to be applicable to all types of business, no separate industry specific standards should be developed as this would restrict the comparability of corporate financial reports. Some groups of companies have banking components as well as businesses in other sectors and it may be problematic to draw boundaries around the entity to be reported separately.

207. It was pointed out that the growing regulatory requirements for banks already create the potential for an incremental (if not separate) financial reporting and auditing regime to be developed through the regulatory returns that are required. For example, the regulator has the ability to require banks to provide incremental information that may also be relevant to the markets, given the concerns expressed by some respondents, for example about the inevitable limitations of neutral single point measurements in assessing the future viability of a bank. Publication of such information on a bank-by-bank or industry-wide basis is one possible way to leverage market forces to drive appropriate behaviours in this sector.

208. However, if this approach is to be taken, it will be important to consider the relevance of that information to market participants and whether it should be more integrated with the financial statements and narrative reporting already required to be provided to the markets. For this reason, the FRC and BIS may wish to remain engaged with the regulators as they consider taking these matters forward.

209. In the preliminary report the Panel suggested that a bank-specific appendix to the Guidance for Directors may be appropriate. This was supported for further consideration by a number of commentators. Such guidance might cover areas such as the tests which are appropriate as part of a going concern assessment in a bank, the need for a more prudent approach to the assessment of asset values than the normal accounting basis in assessing solvency risks, and how risk disclosures might be provided in the annual report of such an entity.

Question 5: Do you have any other comments on matters set out in this report?

210. A number of commentators pointed out that the recommendation that an appropriately prudent mind-set is needed to carry out the going concern assessment suggested that IFRSs should reintroduce the concept of prudence so that accounting records can be used to identify going concern problems leading to their earlier recognition. This is clearly not an issue for the Panel to address, but it is noted that this was also raised by a number of those who provided evidence in the previous phase of the Panel's work.

211. One commentator pointed out that there are continuing reporting obligations for listed companies in relation to situations where a listed company has a going concern problem under the provisions on disclosure and control of inside information in the Disclosure and Transparency Rules of the FSA Handbook. The Panel notes that on-going monitoring of an entity's liquidity and solvency position will enable it to meet this requirement in the same way as is already required. Extending the scope of the going concern assessment process to include a review of solvency issues will enable directors to flag up issues earlier than would otherwise be the case and so ensure a better chance of avoiding business failure. The process will only flush out disclosure requirements in cases where directors have not effectively kept on top of their management information.

212. The Panel recognises a concern that revisions have been made to the Guidance on Audit Committees a number of times over the past few years. However, the demand for greater transparency in the light of the recent financial crisis means that change is inevitable. The success of audit committees in tightening up corporate governance in the past means that they are seen as the most appropriate type of body to implement these improvements. One commentator suggested that internal audit may be able to assist the audit committee in this regard as they could give assurance on the effectiveness of the process and on the reliability of the information produced.

Comments on implementation

213. The recommendations made by the Panel cut across different areas where the FRC has responsibility, highlighting the benefits of the FRC Reform which is currently in progress. It will be up to the FRC to decide how to implement the Panel's recommendations and normal consultation procedures will be an important part of this process. There is a balance to strike between implementing all the recommendations at the same time in order that the Panel's aims can be achieved in one stage and the delay that this might cause, in particular where this relies on an international co-ordination and co-operation. It is likely that there will be some recommendations, such as those connected with ECS, where quick implementation is possible and these may be able to go ahead without the others proceeding at the same time.

214. As pointed out by a number of commentators a full impact assessment will be needed once detailed proposals are developed by the FRC as part of their implementation of these

recommendations. The Panel believes that the benefits of improved corporate behaviours will outstrip the costs and the impact on competitiveness which some commentators believe will result from implementation.

215. The need for safe harbour provisions in respect of the Panel's recommendations was raised by two commentators. The Panel does not envisage that there would be any forward looking disclosures made in an entity's annual report as a result of the recommendations. The reporting set out under recommendation 4 concentrates on the current risks and the process of going concern assessment and so safe harbour provisions may not be necessary. The FRC will, however, need to give this consideration during the implementation process.

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

Tel: 020 7492 2325
Website: http://www.frc.org/about/sharmaninquiry.cfm