The Sharman Inquiry

Going Concern and Liquidity Risks: lessons for companies and auditors

Preliminary report and recommendations of the Panel of Inquiry

November 2011

Responses to Consultation Questions

Responses are requested to the Consultation Questions set out on page 13 of the report. Responses submitted will be published on the Panel of Inquiry's website, unless a respondent requests that their evidence remains confidential. Responses should be printed or typed and set out in numbered paragraphs, clearly indicating the author's name, address and status and whether the response is submitted on an individual or corporate basis. Additionally authors should note from what perspective(s) they are writing, both in terms of their current and past roles and the industry their experience relates to. Submissions by e-mail are preferred (as attachments in Word), with a signed, hard copy to follow.

Concise submissions of ten pages or fewer are preferred; longer submissions should include a single page summary. Respondents may be invited to discuss their comments with the Panel; summaries of any such meetings will be agreed with participants but will not be published.

Consultation responses and enquiries should be addressed to:

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The Lord Sharman

When the Financial Reporting Council asked me to lead this Inquiry in early 2011, the recent credit crisis and subsequent recessionary environment had led to much discussion about the quality of information that companies provide on their financial health and ability to withstand stresses in the short to medium-term. Going concern and liquidity risks continued to be critical reporting and audit issues and the aim of the Inquiry was:

- to identify lessons for companies and auditors addressing going concern and liquidity risks; and
- to recommend measures, if any, which are necessary to improve the existing reporting regime and related guidance for companies and auditors in relation to these matters.

The Inquiry was also asked to have regard to the proposals in the Financial Reporting Council's paper 'Effective Company Stewardship – Enhancing Corporate Reporting and Audit'.

The Panel received much interesting and insightful evidence both in responses to the Call for Evidence and through a number of wide-ranging discussions in meetings with individuals and organisations. We are grateful to all those respondents and commentators for the quality of their submissions.

Although recent events most spectacularly exposed the vulnerabilities of the banks, which has led to many developments relevant to their going concern assessments, the Panel's primary aim was to learn lessons that could be applied more generally. Many of the identified lessons learned by banks (such as the importance of rigorous stress testing) can be applied elsewhere, if appropriately adapted. Chapter 7 also considers whether there is a need to develop a special regime for banks.

The viability of a company's business model and the risks to its success are fundamental aspects of stewardship and governance. The purpose of the going concern assessment and disclosures should be to provide information to stakeholders about these matters and they should be designed to encourage appropriate business behaviours (good risk decisions, informing stakeholders about those risks and early identification and attention to economic and financial distress).

There are a number of ways in which the current requirements present barriers to these desired behaviours: expectation gaps persist about when to give more detailed disclosures about going concern; the perception that a high hurdle for doing so implies less need for a robust going concern assessment process and for stakeholders to understand the key risks and vulnerabilities,

below this threshold; and the binary disclosure model heightens fears that significant doubts disclosed will become a self-fulfilling prophecy of failure.

The purpose of the going concern assessment should be clarified to address the expectation gaps identified. The Panel is also recommending changes that would integrate going concern reporting with the Effective Company Stewardship proposals – a move to a model in which the directors always report how they arrived at the going concern statement, as part of their discussion of strategy and principal risks in the company's narrative report, with the audit committee report confirming that a robust process has been undertaken and demonstrating its effectiveness. Auditors may then only need to signal where the directors fail to adequately describe their process and its outcome.

Outside the financial services sector, the principal focus of the going concern assessment appears to be on liquidity risk. Both solvency and liquidity risks are important considerations in understanding risks to the viability and success of the company. The Panel is recommending that for all businesses the going concern assessment should focus not only on short term liquidity risks but also on solvency risks that could threaten the company's survival over the business cycle or that could cause significant damage to the community and environment, bearing in mind the directors' responsibilities under the Companies Act 2006.

These proposals should encourage greater integration of the going concern issue into the entity's wider on-going risk management and governance processes and reporting, encourage greater openness between companies and investors and enable investors and other stakeholders to be better informed on a 'business as usual' basis about a company's key vulnerabilities.

This initial report is a consultative document. The report sets out the Panel's preliminary recommendations and conclusions. Our principal focus to date has been on developing appropriate recommendations for listed companies. Views are being sought about extending the final recommendations to, or adapting them for, other entities.

The Panel intends to issue a final version of its recommendations in February 2012 in the light of responses received and further discussions held between now and the end of the consultation period on 31 December 2011.

Lord Sharman of Redlynch

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Glossary of abbreviated terms

APB	The Auditing Practices Board.
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 – emergency financial support provided by the Bank of England.
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.*
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.
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.

Chapter 1 - Preliminary recommendations and conclusions

Introduction

1. The background to the Panel of Inquiry is set out in Chapter 2. This report provides a summary of the evidence received by the Panel of Inquiry and sets out the Panel's preliminary recommendations and conclusions. This chapter sets out a summary of those conclusions and recommendations and a series of consultation questions arising from them.

Preliminary recommendations and conclusions

Aim of going concern disclosures

2. Going concern disclosure in the annual report is one element of the audited and unaudited information provided by publicly traded companies which helps stakeholders to assess their solvency and liquidity. Other information such as interim financial reports, shareholder circulars, trading updates, analyst briefings and other regulatory announcements may also help in this respect. To be fully meaningful these pieces of information need to be considered together.

3. 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 which 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.

4. In this context, the primary purpose of the inquiry was to understand, particularly in the light of the financial crisis, whether going concern and liquidity issues are being appropriately managed and reported and whether, in the context of the FRC's ECS proposals, there is need for a change in the way these matters are addressed by companies and auditors.

5. There has been much discussion about why issues concerning the solvency and liquidity of certain banks were not flagged in their audited financial statements and audit reports issued soon before their collapse in 2008. The Panel has not set out to determine in any particular case whether forewarning of failure should or should not have been given. It does, however, note the limited availability of public reports into high impact cases of corporate collapse in the UK and that on-going analysis into the underlying causes of

individual cases of corporate collapse is limited. It is important that if failure occurs, lessons are learned.

Recommendation 1

The Panel recommends that the FRC should seek to establish protocols with BIS and with other regulatory authorities that will enable the FRC to take a more systematic approach to learning lessons relevant to the scope of its functions when significant companies fail, through assessing the underlying circumstances. This might be achieved through a combination of approaches, including analysis of Insolvency Practitioner reports and Inspector reports to BIS and inquiries by the FRC alone or in conjunction with BIS, other regulatory authorities and others appointed by them to investigate or inquire into such circumstances.

Expectation gaps in relation to the going concern assessment and reporting process

6. The financial statements essentially provide a backwards looking perspective on the entity whereas the going concern statement given in accordance with the Listing Rules or the Code provides a forward looking perspective. A significant number of respondents (especially management and auditors but also others) mentioned an expectation gap between what is expected by some users of the going concern assessment and reporting process and what it actually is. This expectation gap is based on there being two different thresholds relating to the going concern issue:

   - The threshold for disapplication of the normal (going concern basis) requirements of the financial reporting standards is when "management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so". Some respondents suggested that going concern disclosures indicating significant uncertainty are intended to contextualise the application or otherwise of the going concern basis of accounting and are therefore only required when the entity is very close to collapse or failure.
   - The requirement of the provision of the Code (and the Listing Rules) is to state that the entity "… **is** a going concern", suggesting to some that the absence of any qualifying disclosures can be taken as a 'guarantee' that the entity will not collapse or fail.

7. Although the purpose of the disclosure requirements in the accounting standards is not explained, the Panel believes they are or should be to provide information about risks to the solvency and liquidity of the entity rather than to contextualise the application or otherwise of the going concern basis of accounting. The Panel believes that the purpose of the requirement for a going concern statement within the Code, and of the requirement in the Listing Rule derived from the Code, is also to provide information to stakeholders about the solvency and liquidity of the entity and about the directors' stewardship and governance in that respect.

Recommendation 2

The Panel recommends that:

a. **The FRC should seek to harmonise, and to clarify, the common purpose of the going concern assessment and disclosure process in the Code and related guidance for directors and auditors) and in FRS 18 – and, in doing so, should reconsider whether the language of the provision of the Code, to the effect that the directors should state that the entity IS a going concern, is too definitive;**
b. **The FRC should engage with the UK LA to seek to maintain the existing congruence of the Code with Listing Rule 9.8.6 R (3), in light of these changes.**
c. **The FRC should engage with the IASB to seek amendments to IAS 1 to accord with the resulting position in the Code and FRS 18.**

The focus of the going concern assessment process

8. Addressing going concern considerations is seen by all stakeholders as a fundamental aspect of the directors' stewardship of the entity and should not be a detached exercise carried out to support the preparation of the financial statements. However, there were a number of areas where different views emerged from the evidence received in relation to the approach to the going concern assessment by the directors.

9. Many respondents drew the distinction between assessing solvency and liquidity:

- 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.
- 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.

10. Investors generally think that both solvency and liquidity are important considerations in the going concern assessment and want to know that the risks associated with both are properly managed. Many other respondents thought that for non-financial services entities, the solvency of the entity was clear from the balance sheet and other financial statements, and that the liquidity assessment was the primary concern. The Panel takes the view that both are important elements, whatever the company's business, and that it would not be appropriate for an entity to be focused solely on liquidity risk. Risks to the

business model and capital adequacy are critical and related elements of managing the prospects of the entity.

11. A key concern which emerged from the evidence and discussions with investors (but also others) is that in assessing capital adequacy there is a need for a more prudent mindset in making the going concern assessment than the more neutral approach that is adopted for purposes of financial reporting.

12. The going concern assessment should focus on the risks the entity takes and faces that are critical to its success or which could cause its business model to fail. A key lesson that emerged for banks in the credit crisis was the importance of stress testing the impact on the entity's solvency and liquidity of a range of scenarios and of considering what level of stress would be necessary to cause the entity's insolvency. The Panel believes that this lesson should be of more general application to companies.

13. Under Section 172 of the Companies Act 2006, directors have a duty, amongst other matters, to promote the success of the company having regard to the likely consequences of their decisions in the long term and to the impact of its operations on the community and the environment. This is very pertinent in considering the extent of stress testing of risks to the business model in the going concern assessment and the consequent risk appetite of the entity. Special consideration should be given to the entity's appetite not only for risks which could lead to consequences for shareholders, but also those that could have a significant impact on the general public or a particular group of stakeholders. For example, the directors of a business providing essential services to the community may conclude that there is a need for relatively intense stress testing of solvency and liquidity risks that could lead to a disorderly discontinuity of those services.

14. Most respondents who commented generally supported the approach to the period of review set out in the FRC's Guidance for Directors. This indicates that: directors should consider all available information about the future at the date they report on their assessment; their review should usually cover a period of at least twelve months from that date; and the extent of the review period is a matter of judgment based on facts and circumstances and it may be appropriate to obtain information for longer periods. The Panel agrees and believes that the indicative minimum review periods set out in IFRS and UK GAAP are more relevant to considering the period over which detailed budgets and forecasts should be prepared than to the period over which other aspects of the review should extend. In particular, the Panel considers that judgment is important in considering the period over which stress tests should be applied and that this should have regard to the period over which identified solvency and liquidity risks are likely to evolve having regard to the economic outlook and business cycles.

Recommendation 3

The Panel recommends that the FRC should review the Guidance for Directors to ensure that the going concern assessment:

- **reflects the right focus on solvency risks, not only on 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 ;**
- **is more qualitative and longer term in outlook in relation to solvency risk than in relation to liquidity risk; and**
- **includes stress tests both in relation to solvency and liquidity risks that are undertaken with an appropriately prudent mindset. Special consideration should be given to the impact of risks that could cause significant damage to the community and environment, bearing in mind the directors' responsibilities under the Companies Act 2006.**

Disclosures about the going concern status of an entity

15. In relation to the reporting model, the Panel notes that many called for better focus of the disclosures in one place, probably the narrative report, rather than the financial statements. The message was better not more. This is in line with the proposals of the ECS work undertaken by the FRC. Such reporting would fit well as part of a discussion of strategy and principal risks within the Strategic report proposed in the BIS narrative reporting consultation.

16. The Panel also notes the desire by investors to understand that the going concern process has been robust. The Panel believes that this could be achieved if the extended audit committee report envisaged under the ECS proposals were to address the audit committee's review of the going concern process and related disclosures in the annual report, demonstrating the effectiveness of the process through highlighting the key risks identified, how they were addressed and whether, and if so why, the directors are comfortable with any risks not fully addressed.

17. The evidence received suggests that there are behavioural disincentives for directors to make frank going concern risk disclosures, except in fairly advanced stages of distress, either as a result of: fear that disclosure may create a self-fulfilling prophecy; an overly optimistic outlook; or a degree of denial. Additionally, lending bank workout teams indicated that too much disclosure can be detrimental to the rescue process as some stakeholders may withdraw support, but early recognition and engagement by management with the issues will raise the likelihood of a successful turnaround.

18. The Panel has also considered whether the current requirements appropriately support what it believes should be the behavioural aims of the going concern assessment and disclosure process (see paragraph 100).

19. The evidence submitted suggests that there are a number of ways in which the current requirements present barriers to these desired behaviours:

    a. Expectation gaps persist about when richer disclosures should be given about the going concern status (see paragraph 6), which can create uncertainty about the value of such disclosures whether given or absent;
    b. A high disclosure hurdle may create a perception that there is less need for a robust going concern assessment process and for stakeholders to understand the key risks and vulnerabilities, below this threshold; and
    c. The fear that disclosure of significant doubts will become a self-fulfilling prophecy of failure is heightened by a binary disclosure model.

20. The Panel believes these factors, acting together, create a climate in which directors are not appropriately encouraged to fully consider the going concern status of the company and to make informative going concern disclosures, other than in fairly extreme cases.

21. As a result, the Panel is recommending changes that would integrate going concern reporting with the ECS proposals – a move to a disclosure model in which the directors always report how they arrived at the going concern statement, as part of their discussion of strategy and principal risks in the company's narrative report, with the audit committee report confirming that a robust process has been undertaken and illustrating its effectiveness.

22. Such a reporting model may engender a greater openness between companies and investors. It would necessarily see a move away from the three category structure of disclosures, at least for directors. It may also be beneficial from a behavioural perspective in enabling investors and other stakeholders to be better informed on a 'business as usual' basis about key vulnerabilities (such as loan covenants) so that, when circumstances do deteriorate, a more proportionate response is forthcoming.

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:

- **confirming that a robust risk assessment has been made;**
- **providing an explanation of the material risks to going concern considered and addressed; and**
- **identifying any that they have not been able to resolve;**

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

Auditor reporting on going concern

23. Auditors currently report on the going concern assessment made by directors as an integral part of their report on the financial statements and their review of other information. The auditor may provide a 'clean' report, an emphasis of matter or a disagreement with the directors' assessment. In practice, the latter category of report is rarely, if ever, seen. The sharp boundary between the other two categories, which coincides with the boundary between categories 1 and 2 in the going concern disclosures for directors, means that entities have further disincentives to provide full disclosure on their risks.

24. Auditor reporting should reinforce the behaviours intended to be encouraged by the above proposals for the directors' going concern assessment process and reporting. If appropriate disclosures were always made by directors, the three categories of auditor report should not be necessary as all annual reports would adequately disclose the directors' assessment of going concern.

Recommendation 5

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

a. **consider moving UK auditing standards away from the three category model for auditor reporting to a statement in the auditor's report as to whether the auditor is satisfied that, having considered the directors' going concern assessment process, they have nothing to add to the disclosures made by the directors about the robustness of the process and its outcome; and**

b. **seek to encourage the International Auditing and Assurance Standards Board to accommodate this approach in the International Standards on Auditing.**

The case of the banks

25. The Panel considered whether banks and other financial institutions are a special case. Banks, but not necessarily other financial institutions, are certainly different from most other types of business in relation to the intensity of their going concern risks. They have high solvency risks because they are very highly geared and they hold assets that are subject to asset value shocks which can quickly erode their relatively thin capital. They also have high liquidity risk because the process of maturity transformation creates mismatches between the maturity dates of their assets and liabilities. They are therefore exposed both to solvency and liquidity shocks. Furthermore, concerns about their solvency, when they arise, can precipitate liquidity shocks. In short, their business model is fragile and built on the confidence of those who fund them with short term money. The Panel concluded that banks therefore need to have a particularly intense focus on the going concern assessment.

26. For the same reasons, banks are heavily regulated and, following the financial crisis, there are a number of on-going initiatives to damp down their risk taking, to increase their minimum regulatory capital levels, to improve their resilience to liquidity shocks, to ensure they undergo and report regularly on stress tests and to make it easier for them to recover from shocks and to be resolved in the event of failure by developing recovery and resolution plans. The responsibilities of the directors of banks are not simply met by placing reliance on the minimum regulatory benchmarks, but by being on top of their going concern assessment all year round, by living and breathing it.

27. A bank's auditor also needs to address its work in this area at as early a stage as possible. Considerable lead time is needed to make its own critical assessment and to follow through if any serious and imminent risk is identified, including raising the matter with the bank's supervisor. Early and open communication between directors, auditors and regulators will provide the greatest possible chance for co-ordination and sharing of information about stresses being experienced and solutions being developed. The May

2011 FSA guidance on the relationship between the external auditor and the supervisor signals the importance of these channels of communication being familiar and effective in both normal and troubled times.

28. One particular issue that has been widely debated recently is the extent of disclosure, both by banks and their auditors, where a bank relies on Government support or ELA from the Bank of England. Government support or ELA may be a critical factor on which the bank's survival depends, in some difficult circumstances. Untimely disclosure of such support could damage confidence in the bank. As a result, difficult decisions may have to be made about the extent of disclosure, both by banks and their auditors.

29. Where disclosure is considered necessary to comply with accounting standards, company law or the Listing Rules, this may conflict with a regulator's objective of financial stability and a consequent desire for secrecy. Under the current legal framework it is for the directors and auditors to determine whether to make the necessary disclosures, not the regulators. However, it is important for the matter to be discussed with the regulators because the fact of the proposed disclosure may in itself create further risk of stress to the going concern status of the bank, potentially raising the level of escalation and the need for additional actions to address those stresses.

30. The Panel has concluded that, notwithstanding the special nature of the risks and the importance of banks to the financial system and its stability, absent a legal basis for doing so, failure to provide the necessary disclosures appropriately reflecting the going concern status of the bank, or to give the required audit reporting, would constitute a breach of the directors' or auditor's duties.

31. In that context, the Panel has considered whether, as suggested by some commentators, there should be a separate disclosure regime for banks and their auditors in relation to the going concern assessment. What has been suggested is that the bank and the auditor would not make public disclosures about significant uncertainties (such as are implicit in the need for Government support or ELA) but would be required only to make disclosure to the regulators and, in the case of the auditor, also to the bank's board. An alternative approach might be to introduce a specific derogation permitting delayed disclosure in accounts, subject to meeting a public interest test that could be subject to approval by the regulatory authorities.

32. The Panel recognises that such a regime would, in effect, further subrogate the rights of market participants – to be properly informed about the risks – to the rights of society to enjoy financial stability. As discussed in paragraph 176, there is a precedent for such derogation in relation to inside information, but this is limited to the delayed disclosure of the receipt of ELA by the bank. Furthermore, it should be recognised that any such change would require changes to EU law as well as to UK law and regulations.

33. If it were considered appropriate for there to be such a regime, the Panel believes this is a matter of public policy that should rightly be considered and decided by Parliament (or by

the relevant EU legislative organs) at the request of the Bank of England as the primary guardian of the public interest in financial stability. Accordingly, it is beyond the remit of the Panel and of the FRC and therefore the Panel makes no specific recommendation on this point.

34. The Panel also found the arguments advanced for considering the need for a separate financial reporting and auditing regime for banks (see paragraph 195) interesting. The Panel believes that its recommendations are responsive to the issues raised in relation to the going concern assessment, without the need for a fundamentally different approach for banks in this respect. However, there may also be merit in the FRC considering enhancing the Guidance for Directors by highlighting the special considerations for banks (perhaps through the introduction of an Appendix to the document). If so, the Panel believes that it will be important to do this in a way that does not detract from the importance to non-financial entities of many of the lessons learned by banks in the crisis in relation to their assessment process.

35. Although the wider issue of a separate financial reporting and auditing system for banks was only raised spontaneously by a small number of commentators and is outside the Panel's remit, the Panel concluded that it could merit further debate. In commenting on the recommendations and conclusions set out in this report, commentators may wish to provide a wider range of opinions on this matter.

Consultation questions regarding preliminary recommendations and conclusions

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?

Question 2:

Do you support each of the five recommendations set out in Chapter 1? Please give your reasons for agreeing or disagreeing with each of the recommendations.

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.

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 (see paragraphs 232 to 234)?
- The merits of a separate financial reporting and auditing regime for banks (see paragraphs 235 to 236)?

Question 5:

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

Responses to the consultation questions should be directed to the Sharman Secretariat. Details are provided on the inside front cover of the report.

Chapter 2 – Introduction

Background to the Inquiry

36. The recent financial crisis began in 2007 with defaults on sub-prime mortgages in the US affecting the valuation of financial instruments and restricting credit facilities in financial markets. As the credit crisis began to develop, the FRC issued in November 2008 an update of guidance on going concern and liquidity risks for directors of listed companies and this was finalised in November 2009[1] after consultation, to be applicable to all companies for accounting periods ending on or after 31 December 2009. This brought together the requirements of company law, accounting standards and the Listing Rules on going concern and liquidity risk and provided further guidance on applying them.

37. In addition, the APB's two Bulletins issued in 2008[2] provided guidance to auditors on the requirements of auditing standards and guidance issued by the APB. The first provided guidance on matters that auditors may need to consider when conducting audits in an economic environment where credit facilities may be restricted and the second updated aspects of the first Bulletin and gave guidance on relevant factors to consider during audits being conducted in early 2009 when the UK and Ireland was experiencing a recessionary economic environment.

38. As part of its contribution to learning lessons of more general application from the credit crisis, the FRC published the ECS discussion paper in January 2011[3]. The financial crisis had highlighted the importance of the identification, analysis and management of risk, not only in financial services. The FRC's aim in publishing ECS was to reduce the likelihood that this message would be forgotten, by increasing transparency in the way that directors report on their activities, including their management of risk. It was clear that any lessons identified in connection with the particular challenges faced by directors, management and auditors where companies face going concern and liquidity risks would need to be put in the context of the recommendations made in ECS.

39. As discussed in ECS, important questions had been asked about the effectiveness of audit in circumstances where banks failed shortly after their financial statements received unqualified audit opinions (see, for example, paragraphs 40 and 41). Those questions included whether the risks and uncertainties facing the banks were adequately described and/or it was appropriate for the financial statements to be prepared on a going concern basis. These questions, which were asked in a number of UK and international reports

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[1] *Going Concern and Liquidity Risk: Guidance for Directors of UK Companies 2009* published by the FRC in November 2009 can be accessed at http://www.frc.org.uk/publications/pub2140.html

[2] *Bulletin 2008/1: Audit Issues when Financial Market Conditions are Difficult and Credit Facilities may be Restricted* was published in January 2008 by the APB and can be accessed at http://www.frc.org.uk/apb/publications/pub1486.html. *Bulletin 2008/10: Going Concern Issues During the Current Economic Conditions* was published by the APB in December 2008 and can be accessed at http://www.frc.org.uk/apb/publications/pub1824.html.

[3] *Effective Company Stewardship: Enhancing Corporate Reporting and Audit* was published by the FRC in January 2011 and can be accessed at: http://www.frc.org.uk/publications/pub2486.html

and other fora[4] arising from the credit crisis, also apply by inference to the effectiveness of going concern assessments by directors.

40. The House of Commons Treasury Committee commented (in the Third report arising from its inquiry into the banking crisis[5]) that:

"The fact that some banks failed soon after receiving unqualified audits … does cause us to question exactly how useful audit currently is."

41. Similarly, the House of Lords Economic Affairs Committee commented in its recent report on *Auditors: Market concentration and their role*[6] as follows:

"Since statutory audit is concerned mainly with companies' financial statements for the past period, it is largely backward-looking, though it includes a view that the company remains a going concern. This limitation is not always understood. Auditors' endorsements of financial statements are sometimes taken as forecasts of good financial health. Misunderstandings on these lines help form an "expectations gap". Critics who do understand its role also question whether statutory audit meets all today's needs and advocate more emphasis on the going concern statement, the forward looking element in an audit report."

42. Additionally, in their public reports dealing with the audits they reviewed over the last three years (primarily audits of financial statements for the three years from 2007 to 2009), the FRC's Audit Inspection Unit has continued to identify issues in relation to the audit

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[4] These include, for example:

- the Treasury Select Committee;
- the House of Lords Economic Affairs Committee;
- the introductory section of the EU Green Paper *Audit Policy: Lessons from the Crisis*, published by the European Commission in October 2010, which can be accessed at http://ec.europa.eu/internal_market/consultations/docs/2010/audit/green_paper_audit_en.pdf ;
- evidence given to the Hearing of the US Senate Subcommittee on Securities, Insurance and Investment into *The Role of the Accounting Profession in Preventing Another Financial Crisis* – April 2011, by Jim Doty (PCAOB Chair), Anton Valukas (the US Lehman investigator), Lynn Turner (former SEC Chief Accountant) and others which can be accessed at http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=0f533e5b-dc43-4fc2-a415-5df2ae8806da
- *Misjudging Risk: Causes of the systemic banking crisis in Ireland*, published in March 2011by the Commission of Investigation into the Banking Sector in Ireland, which can be accessed at http://www.bankinginquiry.gov.ie/Documents/Misjuding%20Risk%20-%20Causes%20of%20the%20Systemic%20Banking%20Crisis%20in%20Ireland.pdf; and
- remarks by certain PCAOB members launching the PCAOB's Concept Paper on auditor reporting, which can be accessed at http://pcaobus.org/Rules/Rulemaking/Pages/Docket034.aspx .

[5] *Banking Crisis: reforming corporate governance and pay in the City* was published by the House of Commons Treasury Committee in May 2009 and can be accessed at www.parliament.uk/business/committees/committees-archive/treasury-committee/bankingcrisis/

[6] *Auditors: Market concentration and their role* was published by the House of Lords Select Committee on Economic Affairs in March 2011 and can be accessed at www.parliament.uk/business/committees/committees-a-z/lords-select/economic-affairs-committee/inquiries/auditors-market-concentration-and-their-role

work done in relation to the going concern assessment, though improvements have been noted over the period.

43. Against this background, on 8 March 2011, the FRC announced the launch of this Inquiry. The purpose was to identify lessons for companies and auditors about the going concern assessment, drawing on the experience of dealing with these issues in times of difficulty (including during the credit crisis), and to help to inform the debate about the issues addressed in ECS. The Panel was asked to recommend measures, if any, which are necessary to improve the existing reporting regime and the related guidance for companies and auditors in relation to these matters. The Panel's detailed Terms of Reference are included at Appendix 1.

44. The Panel published a Call for Evidence in May 2011, which is also included at Appendix 2. Sixty two pieces of written evidence have been received by the Panel. These are listed in Appendix 3 and those which are not confidential are now available on the Panel's website[7]. Additionally, confidential meetings have been held by Panel members with thirteen individuals or groups of individuals and organisations.

Evidence of an expectation gap

45. The general tenor of comments about the speed with which the banks experienced going concern issues, without any signal of such events by the directors or auditors during the financial crisis, has been to ask whether this was either because the directors and auditors did not perform their role effectively or because that role was inadequately defined.

46. Of course, there is a third possibility – that the directors and auditors could not reasonably have provided the requisite forewarning in the particular circumstances, for example because of the speed of collapse. The absence of this suggestion in most commentators' questions suggests that they discount this possibility. This does not usually appear to be because they believe that the absence of forewarning should provide a guarantee of viability. Rather, the implication is that the circumstances of the collapse are so severe that they are sceptical that the symptoms could not have been spotted sufficiently early to provide forewarning in the particular circumstances. The directors' and auditors' assessments are undertaken behind closed doors. Absent an insider's view, perhaps outsiders are inevitably sceptical, particularly when, with hindsight, they believe that the symptoms should have been spotted.

47. In turn, this scepticism breeds concern in some quarters that the root cause may be that the directors are aware of the symptoms and risks but are either too optimistic in their assessments of the prognosis, or too concerned about their self-interests, to make adequate disclosure, and that the auditors' incentives to challenge management are misaligned and as a result their propensity to modify their audit reports is reduced.

[7] See: http://www.frc.org.uk/about/sharmaninquiry.cfm

48. Directors and auditors have the insider's view but are not independent in assessing their own effectiveness. In any case, as is reflected in the evidence received by the Panel, whilst the majority of such 'insiders' contend that they did what was necessary and that more could not have been done, others amongst them believe that there are lessons to learn and that more can be done.

Research into financial and economic distress and going concern issues

49. As part of its work, the Panel has undertaken a limited review of published research into aspects of the going concern issue. The Panel has also undertaken some new analysis into UK companies that appeared to experience financial or economic distress or failure during 2008 and 2009. This work is summarised in Appendix 4 of the report.

50. The Panel has not set out to determine in any particular case whether forewarning of failure should or should not have been given. This could not be achieved in any case without detailed investigation of individual cases and is beyond the remit of the Inquiry.

51. The Panel has, however, noted the limited extent and nature of public reports into high impact cases of corporate collapse in the UK, in contrast to the position in certain other jurisdictions, notably in the US (the Valukas Report on Lehman Brothers) and in Ireland (the Nyberg Report). While research into the circumstances surrounding the government support provided to the Royal Bank of Scotland has been undertaken, the publication of any report into the findings has been delayed by the need for an independent review. Furthermore, the Panel notes that research into the underlying causes of corporate collapse is limited. Accordingly, the Panel recommends steps that might be taken to establish a more systematic approach to learning lessons when significant companies fail through its own inquiries[8] and working with other regulatory agencies.

Recommendation 1

The Panel recommends that the FRC should seek to establish protocols with BIS and with other regulatory authorities that will enable the FRC to take a more systematic approach to learning lessons relevant to the scope of its functions when significant companies fail, through assessing the underlying circumstances. This might be achieved through a combination of approaches, including analysis of Insolvency Practitioner reports and Inspector reports to BIS and inquiries by the FRC alone or in conjunction with BIS, other regulatory authorities and others appointed by them to investigate or inquire into such circumstances.

[8] It has recently been proposed that the FRC should undertake supervisory inquiries at its own initiative into significant matters of concern in *Proposals to Reform the Financial Reporting Council*, A Joint BIS and FRC Consultation, which was published in October 2011 and can be accessed at: http://www.frc.org.uk/documents/pagemanager/frc/Reform/FRC%20reforms%20condoc.pdf

Scope of work of the Panel of Inquiry

52. The Panel considered whether anything can be learned from previous cycles of corporate collapse and attempts to address the lack of forewarning of failure. Despite the very different nature of the circumstances around individual collapses, the incidence of such collapses is 'cyclical'. Similar questions, with similarly sceptical undertones, have been raised many times following earlier such events and the path of the subsequent discussion has usually been along the following lines:

    - Directors and auditors contend that they did what was asked of them and that what was asked of them was broadly reasonable in the circumstances, recognising the limits of a forward looking exercise. Despite that, either it was too difficult to predict with sufficient certainty the path of events unfolding in the way that it did, or those events unfolded too quickly, for them to provide adequate, or any, forewarning in the particular circumstances, as in the case of the sudden collapse of Rolls Royce in 1971;
    - An expectation gap (between what stakeholders expect of the role and what directors and auditors actually deliver) is postulated and the root causes considered;
    - Work is undertaken to identify what improvements can be made to the roles of directors and auditors and their disclosure or requirements or to educate users about those roles, the meaning of the disclosures or reports by directors and auditors and the perceived limits of what can be achieved;
    - Some academic research is done to assess the expectation gap but detailed investigation of particular cases is not usually undertaken. The research is somewhat limited in approach, focusing on particular possible components of the gap – the propensity of auditors to modify their opinions for going concern matters in the face of significant risks; the causes of collapse; the potential early warning signs of collapse etc. Academic research is necessarily undertaken from the perspective of an outsider looking in and has limited capacity to assess the facts fully; and
    - Adjustments are made to the requirements for directors and auditors to address the expectation gap … and the cycle goes around again.

53. The Terms of Reference for the Panel make it clear that the Panel's examination should cover all aspects of the FRC's enhanced guidance for directors and auditors in the recent crisis, which was partly intended to break this pattern of cyclical corporate collapse. The enhancements were made proactively and with comprehensive input from the stakeholder community and there has been strong endorsement of this process and of the value of the output across the whole spectrum of respondents to the Call for Evidence.

… we wish to emphasise [our] strong support for the existing FRC Guidance on Going Concern and Liquidity Risk published in November 2009 … [We] greatly valued [our] involvement in the FRC processes leading up to these publications, which has provided very valuable assistance to companies and their boards.

Corporate respondent

54. Despite this and despite past attempts to address the going concern expectation gap, it is evident from the comments referred to in paragraphs 39 to 41 and from responses to the Call for Evidence, that it has not yet been fully closed. The Panel is not aware of any comprehensive analysis of this expectation gap having been undertaken in previous attempts to address it. Accordingly, in addition to looking at the specific elements of the FRC guidance on monitoring, assessing and reporting on going concern and liquidity risks, the Panel has sought to identify the potential sources of the expectation gap very broadly in considering the evidence it has received, in identifying lessons that can be learned from recent experience and in making recommendations for further improvements.

The remainder of this report

55. In Chapter 3 of this report, the Panel summarises the evidence and other information received in relation to the expectation gap. This provides a suggested outline of what individual stakeholders are looking for, which leads to the Panel's recommendations as to what the aim and purpose of the going concern assessment made by a company should be. The remainder of the report then goes on to assess whether the current approach adequately addresses this aim.

56. Chapter 4 considers the evidence received about expectations of the going concern assessment process and sets out the Panel's recommendations for refocusing these expectations in some areas. Chapter 5 considers the evidence received as to the extent and nature of the disclosures that should be made about going concern and liquidity risks and sets out the Panel's recommendations linking these disclosures to the FRC's ECS proposals. Chapter 6 considers, in light of the foregoing discussion of expectations, what the role of the auditor should be.

57. Finally, Chapter 7 addresses the question whether and, if so, how the going concern assessment for banks and other financial institutions should be different.

Chapter 3 – What aim for the going concern assessment?

Analysis of the expectation gap: different thresholds

58. That there is an expectation gap is mentioned by a significant number of respondents and other commentators. Most suggest that the expectation gap results from an expectation by some stakeholders that the absence of disclosure by directors and the absence of a modified audit opinion in respect of the going concern status of the entity can be taken as a 'guarantee' that the entity will not collapse or fail. This leads such stakeholders to suggest the process has failed every time an entity fails without a forewarning of significant doubts about survival.

> *Some readers assume that the fact that the company has performed a going concern assessment, and that auditors have reviewed it, is a guarantee of the sustainability of the business.*
>
> *Accountancy profession respondent*

> *… there remains an 'expectation gap' between users and preparers. The public expectation tends to be that the going concern assessment provides a strong indication about the health and future viability of the company whereas the actual requirement is for an assessment as to whether it is appropriate to prepare the financial statements as a going concern, on the basis that survival is a realistic outcome.*
>
> *Accountancy profession respondent*

59. At the other end of the spectrum, some suggest that the expectation gap is because the threshold between being a going concern and a gone concern is too hard to breach – they believe that (based on the language in IAS 1, paragraph 25[9]) the threshold is only breached if there is no realistic alternative to liquidation and the directors have made plans to liquidate. Stating this in another way, they say that an entity is therefore a going concern unless there is no realistic alternative to liquidation which they believe would only be in the very late stages of financial distress. The implication is that those with this view think this is the right threshold and that the problem is that some stakeholders erroneously think the threshold is much lower than this and expect forewarning at an earlier stage of distress.

> *Accounts (and audit report) disclosure has the aim of deciding whether the company no longer has a realistic alternative to an insolvency procedure, because, in such a case, the basis of accounting must be changed to the fundamentally different break-up basis. Disclosures in accounts (and emphasis-of-matter by auditors) aim only at informing shareholders – albeit in a graduated way, with more disclosure the more uncertain the case is – about the directors' decision, with reasons, that there is a realistic scenario in which the company survives. This*

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[9] Paragraph 25 of IAS 1 states that: "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." The equivalent requirement under UK GAAP is in paragraph 21 of FRS 18.

is the case even if the directors judge that the realistic scenario is one in which the company will be "rescued".

Accountancy profession respondent

60. One commentator who had concluded that the threshold is too hard to breach suggested that "no realistic alternative to liquidation" could be interpreted as only being "when the liquidator was in the taxi on the way to the office". He suggested this was far too late in the process of distress for the related disclosures to be useful[10]. He cited experience of an entity where he thought it was likely the entity had made the auditor aware that it expected to default on a loan within a few months of the audit report date but where the directors did not disclose any significant doubts about the entity continuing as a going concern and the auditor had not modified the audit report. He added that the reason this was critical was that paragraph 26 of IAS 1 only requires disclosure when there is "significant doubt" about the going concern status of the entity and the requirement for an emphasis of matter paragraph in the audit report is linked to the same threshold as for the directors. Therefore the trigger for any disclosure is only when there is significant doubt (a high hurdle) about what is already a too hard to breach threshold.

61. Yet another respondent suggested that it is the language of the requirement in the Listing Rules and in the Code for the directors to state that the entity "**is** a going concern, …" (*emphasis added*) that creates the expectation gap. The suggestion here appears to be that this is too definitive a threshold and that some stakeholders may be expecting that few companies could make such a definitive statement and therefore that more should be disclosing significant doubts.

62. The Panel notes that although the Listing Rules and the Code do state the requirement in this way, ever since the first guidance was published for directors on implementing this provision of The Combined Code[11], the application of this provision has always been illustrated in the guidance with a statement along the lines that "the directors have a reasonable expectation that the entity will continue in operation for the foreseeable future and therefore have prepared the financial statements on a going concern basis".

63. The difference in the way that the going concern threshold is described is likely to have an impact on the expectation gap which has been reported. It is also likely to have an impact on the perceptions of different players as to the behavioural dynamics associated with the going concern issue. As the directors see the threshold as a relatively high hurdle, they say they are reluctant to make going concern disclosures about significant doubts except in fairly dire circumstances. This is because they fear the consequences of being open will be to signal that the company is on the brink of collapse and will therefore create a self-fulfilling prophecy.

[10] See also Moody's Global Corporate Finance Special Comment Paper: *Going Concern Warnings: Surprisingly Few, Unhelpfully Late – August 2009*

[11] *Going Concern and Financial Reporting: Guidance for directors of listed companies registered in the UK* was published by The Committee on the Financial Aspects of Corporate Governance (the 'Cadbury Committee') in November 1994.

64. As well as being fearful of the outcome of disclosure, directors are also often inherently optimistic about the company's prospects and can be disinclined to recognise the implications of a deteriorating financial or trading performance.

> *Early recognition of issues which give more time to deliver a consensual solution and decisive management action to execute the financial and operational turnaround are key ingredients of success.*
>
> *Conversely late recognition of issues, management in denial or late or inappropriate action and failure to secure a stable platform through key stakeholder support for the turnaround are all likely to increase the risk of failure.*
>
> *Finance provider respondent*

65. In considering the nature of the going concern threshold, the Panel was also interested in different perspectives on the differences between the going concern assessment and the working capital statement provided by respondents to Question 6 of the Call for Evidence[12]. Most thought that the work effort for a working capital statement was more than for a going concern statement, some suggesting that the higher level would not be appropriate for the going concern statement.

66. Most also thought that the level of conviction required in order to make a working capital statement was higher than that required for a going concern statement or at least that in practice it was done with more rigour. Different reasons were given:

- the working capital statement is more definitive – this respondent cited "reasonable expectation" as opposed to "has sufficient working capital";
- there was new capital being raised;
- there was a sponsor involved;
- the working capital statement was for equity providers whereas the going concern statement was for debt providers; or
- there was more liability on a prospectus.

67. Some commentators highlighted differences in the process which included different elements, such as confirming facilities and more focus in working capital statements on downside scenarios. Other differences that the Panel has noted include that the working capital statement specifically references the period covered – though in practice the assessments often look further than that. The going concern assessment on the other hand is undertaken with reference to a specific minimum period but reported on with vague wording "foreseeable future". Additionally a working capital statement cannot generally be qualified.

[12] See Appendix 2

Analysis of the expectation gap: different perspectives

68. The going concern assessment is forward looking. A number of respondents reminded the Panel of the important differences between the perspectives of holders of equity capital on the one hand and holders of debt capital and other creditors on the other, with regard to the future viability of the entity. The first holds a residual claim on the assets of the entity and the second a fixed (or determinable) and superior claim on those assets (liabilities).

69. A limited liability company starts life with assets contributed by its shareholders. They represent its capital. The shareholders do not have an absolute right to claim back these assets except if the Courts agree (usually on liquidation of the company). This is a key term of the contract that the company of shareholders enters into in exchange for its limited liability status.

70. In return for their capital contribution, the shareholders obtain two conditional rights (see below). The first is the right to appoint themselves or their agents - the directors - to control the company primarily in their interest. The second is the right to enjoy the benefit of the company's present and prospective assets, after first allowing in full for the claims of all others (creditors) over those assets (a residual interest). Furthermore, the shareholders are not required to contribute further capital if losses consume the capital they have already contributed. Excess losses fall on the creditors. In effect, shareholders have the right to take profits but to leave excess losses for the creditors to bear.

71. Creditors' claims therefore have priority over the shareholders' right to enjoy the benefit of the assets. However, when the company is profitable, they have no interest in those assets beyond their claim but they bear the risk that excess losses may limit the company's ability to meet their claims in full (credit risk) as well as the risk that the entity will not be able to settle their claims when due (liquidity risk).

72. This asymmetry creates a moral hazard for directors acting primarily in the interests of shareholders - they might take greater risks than they would otherwise, in the knowledge that, whilst resulting gains would benefit the shareholders, their exposure to resulting losses would be limited. There are five principal sources of protection to mitigate this risk for creditors:

    a. The directors' fiduciary duties require them to promote the success of the company having regard to the likely consequences of their decisions in the long term and to the impact of its operations on the community and the environment and there are sanctions for inappropriate behaviour. There are also significant penalties for directors who continue to trade whilst insolvent. These measures aim to provide incentives for directors to manage the company's affairs primarily in the interests of shareholders, but also with a view to protecting the interests of creditors and others.
    b. The capital of the company provides a buffer to absorb losses that would otherwise damage creditors' claims. Once contributed, capital cannot be withdrawn unless the

courts, having regard to the interests of creditors, approve it or the company is liquidated and all creditors' claims are first met.

c. The shareholders' rights to control and to enjoy the benefits of the company's assets are conditional at all times on the company:

- having the capacity to meet the aggregate claims of others over its assets (a capital adequacy or solvency[13] condition); and
- being able to meet each claim over those assets at such time as each claim is due to be settled (a liquidity[14] condition).

Claims are taken into account for this purpose whether they are contingent or absolute and whether they are due immediately or at some time in the future. If at any time these conditions do not prevail, the company is insolvent. A critical consequence of insolvency is that shareholders lose the right to control the company primarily for their benefit through the appointment of the directors. Control passes to an appointed insolvency practitioner who exercises it primarily for the benefit of the company's creditors.

d. Creditors have and can establish legal rights. In the first instance, they will seek compensation for the risk they take by demanding a commensurate return. They may seek credit insurance. They could even seek to counter their asymmetric downside risk by sharing in the upside risk of the business under an option to convert their claims to an interest in the capital of the company at a fixed price. They may also seek to establish a range of other contractual terms to mitigate or enable them to better manage their credit and liquidity risks if these risks materialise. Such terms may grant the creditor: access to inside information to monitor its risk; security or collateral rights over assets; or triggers (covenants) to accelerate the settlement of their claims, to enhance their returns, or to give them greater control when liquidity or credit risks are heightened. Creditors who provide resources may reserve title to the resources they contribute. This would enable them to withdraw those resources in the event of their claims not being met when due.

e. Creditors may have the benefit of some specific or general protections under laws or regulations. For example, depositors are protected from bank failure under the Financial Services Compensation Scheme; and the establishment of regulators with the power to intervene to limit the risk of discontinuities in service in systemically

[13] Solvency in this document refers to balance sheet solvency, the insolvency test for which is set out in Section 123(2) of the Insolvency Act 1986. Under the interpretation of this test by the Court of Appeal in BNY Corporate Trustee Services Ltd v Eurosail UK 2007–3BL PLC & Ors [2011] EWCA Civ 227, a company will be solvent unless it has gone past the "point of no return" in terms of prospects and its ability to continue in existence. This test is not simply a narrow comparison of value of assets and liabilities reported in the entity's financial statements. It also includes a wider consideration of the entity's economic viability and of the economic value of its current and future assets and liabilities.

[14] Liquidity in this document refers to cash flow solvency, the insolvency test for which is set out in Section 123(1) of the Insolvency Act 1986. Under this test, the entity is solvent unless it is proved to the satisfaction of the Court that the company is unable to pay its debts as they fall due.

important industries such as financial services and utilities provide a measure of general protection.

73. The ultimate risk to the going concern status of an entity is the risk of the entity not being able to pay all of its fixed claims (liabilities) out of its assets (solvency risk). The tipping point arises when the aggregate value of the assets is less than the aggregate value of the fixed claims (insolvency) – beyond this point there is no value in the claims of equity holders and rationally they would no longer support the entity. Beyond this point, the assets would therefore be liquidated to repay the fixed claims as far as is possible.

74. However, even a company that is solvent may be at risk of being unable to meet its liabilities as they fall due (liquidity risk). This is the risk that it cannot convert sufficient of its assets to cash ('market' liquidity risk) and that it does not have available to it sufficient existing or new sources of liquid assets (i.e. cash or access to new equity or debt capital that can be drawn down in cash) ('funding' liquidity risk), when its liabilities are due. These risks may result in a default even if the entity is ultimately judged to be solvent.

75. Such a default, and indeed the inevitability of such a default, creates a situation where control over the entity may be transferred from the shareholders' representatives (management) to creditors' representatives (an insolvency practitioner) whose primary role will be to maximise the recovery of the creditors' fixed claims. These liquidity risks can therefore also heighten solvency risk, for example because there may be losses from forced sales that were not otherwise anticipated in assessing the value of the assets.

76. Although risks to the going concern status of an entity have different implications for both groups, they have a strong mutual interest in avoiding the entity approaching the point where it would cease to be a going concern. This disenfranchises the holders of equity from sharing in the potential future value which might otherwise accrue to them if the entity were to continue as a going concern. It may also increase the size of the potential losses suffered by those with fixed claims as the value of many of the assets of an entity are likely to be reduced if they cannot be recovered through productive operations and if forced sales or scrapping are required.

77. Other stakeholders[15] also share in that mutuality of interest, including employees in terms of their future earning capacity, the Government in terms of tax receipts and welfare costs of unemployment as well as future customers and suppliers in terms of potentially reduced choice. In certain strategically important industries there may also be the

[15] All stakeholders have a common interest in the continuing prosperity of the entity. In bankruptcy, all stakeholders (whether equity or debt holders, employees, customers, suppliers or wider members of society) potentially suffer significant disruption and may experience economic and financial losses. The prosperity of the entity also goes to the heart of the directors' duty under Section 172 of the Companies Act 2006:
"*… to act in the way [they] consider[s], in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to …* the likely consequences of any decision in the long term, …the interests of employees … the need to foster … relationships with suppliers, customers and others … the impact of the company's operations on the community and the environment …"

potential for disruption to essential services or the economy as a whole, so that there may be a wider public interest, the protection of which may be vested in regulators.

78. As a result, the Panel believes that there is a broad range of stakeholders whose expectations should be considered. The Panel received input from a wide range of stakeholders and the following assessment of their expectations is based on that input.

Investors

79. Investors want to know that management has been through a robust process that has been implemented effectively so that going concern considerations are fully integrated into day to day management of the business, rather than being a periodic process that is applied when financial statements are being prepared. These are culturally different approaches – the preferred approach is consistent with a stewardship/governance purpose whereas the other approach is more consistent with a more limited financial statement/accounting policy assessment purpose.

80. Investors (and others) emphasised the importance of robust governance with an effective challenge to management. It is important for those charged with governance to lean against the natural optimism of management.

81. Generally the 12 month minimum period of assessment was considered satisfactory but there were a number of respondents who thought it would be sensible to harmonise the period internationally – the UK requirement is for a longer minimum period than the international requirement. One reason the UK period makes sense is that it is linked to the stewardship and governance cycle – the period from one annual report and annual meeting to the next when, arguably, management's franchise is renewed.

> *… perhaps the FRC and the Government should seek out some international harmonisation on whatever basis is considered most appropriate. This may be an issue for IASB's Future Agenda consultation expected later this year.*
>
> *Corporate representative respondent*

82. Investors and some others pointed out that there are many ways in which information finds its way into markets other than through the annual report. Some are official channels for the company (prospectuses, required price sensitive disclosures; analyst presentations etc.) and these should be fully integrated with other aspects of the going concern consideration so that, when necessary, updates on important going concern considerations are given at the same time. Other information channels are not official and may reflect information about the business from employees or other stakeholders. Companies should pay heed to this sort of information. One way in which it may be apparent that such information is affecting market perceptions is when equity prices or credit spreads move unexpectedly. Companies should monitor and understand the reasons for such changes and reflect them back into their going concern process.

> *Investors do not necessarily rely on accounts to understand the stresses a company faces … they are more likely to use preliminary announcements, external analysis, information from their dialogue with company boards and management, market prices, perceived outlook, etc. The accounts are essentially a confirmatory document and are largely published some time after the events to which they relate.*
>
> *Investor representative respondent*

83. Another point that was made by a number of respondents was that the going concern assessment process is a part of a wider management process linked to the strategic development and management of the business. It should, as far as possible, be integrated with that both in terms of processes and reporting around strategy and risks, so that an integrated story is provided to stakeholders.

Debt providers

84. Information on going concern in the annual report is primarily of confirmatory interest to bank lenders and credit rating agencies as this is often not in enough detail and is provided too late. Cash flow information is available to such debt providers through banking history and other private information channels from the company. Other debt providers may be much more reliant on publically available information, including the annual report.

> *Whilst audited accounts form a part of information reporting requested by a Bank, the closer relationship typically enjoyed between Bank and Customer coupled with the additional information / disclosure requirements in debt documents result in limited additional value from going concern or liquidity reporting.*
>
> *Banking respondent*

85. A number of bank lending workout teams also said that too much disclosure can be detrimental to a rescue process as some stakeholders may withdraw support abruptly.

> *Disclosure regarding trading terms and performance against terms along with overdue creditor positions such as HMRC time to pay arrangements in audited accounts, would provide useful additional information. This needs to be balanced against the risks of negative trade credit or market reaction destabilising a fragile business.*
>
> *Banking respondent*

Other stakeholders

86. All stakeholders are interested in the story of the company and what risks it faces that are critical to its success or that could cause its business model to fail. Under Section 172 of the Companies Act 2006, directors have a duty to promote the success of the company, having regard to all of its stakeholders as well as the community and the environment.

Such stakeholders have no special access to information and are reliant on publically available information, including the annual report.

The purpose of the going concern assessment

87. Many respondents to the Call for Evidence (and other commentators) have pointed out that the financial statements essentially provide a backwards looking perspective on the company's performance. They contrast this with the going concern assessment, which is a forward looking assessment of the company's ability to continue in operation. However, the assessment of whether an entity is a going concern (expected to continue in operation indefinitely) is embedded in the financial reporting process. As noted earlier, some believe that the expectation gap may be related to the fact that the going concern assessment is believed by some to be entirely for the purpose of making an accounting policy decision rather than to convey to stakeholders useful information about the likely economic and financial viability of the entity.

88. The history of the going concern concept has some relevance here. Early in the development of accounting, it was recognised that periodic statements of account of the commercial activities of an entity could be drawn up from different perspectives about the future of the entity. The accounting information most useful for users might be different depending on whether the entity was or was not expected to continue in operation indefinitely.

89. For example, allocating the cost of an item of fixed plant between the current and future periods to reflect the expected consumption of its productive capacity over several periods of account would value the item at the unallocated portion of the cost at the end of the current period. This might be appropriate, if the entity is expected to continue indefinitely and the plant can continue to be used economically in production until fully consumed.

90. However, this might not be so if the entity has a limited life. There might not be sufficient future production to fully consume it; and the economic value of the remaining productive capacity of the asset might be lower than the reported value, if it were to be sold or scrapped when production ceases. So, a liquidation or break-up basis valuation of the asset may be more appropriate.

91. Similarly presenting a maturity profile of the assets and liabilities might be useful if the entity is a going concern. It would not be if it is expected that operations will cease soon after the end of the period and that the entity will immediately sell its assets and pay its liabilities – all items would be current.

92. Originally, therefore the relevance of the going concern (or continuity) concept in accounting developed out of this idea that, in order to be useful to users, the accounting information should be prepared on the basis of an appropriate perspective of the operational future of the entity. Since most commercial enterprises are expected to be

going concerns, the convention was adopted that, unless there is contrary information, an entity should be assumed to be a going concern when drawing up financial information.

93. This concept was already established in accounting and auditing literature in the late 19th Century and was acknowledged as a generally accepted accounting concept by 1927[16]. It was subsequently incorporated into accounting standards as these were codified in the mid-20th Century, first in the US and subsequently in the UK in SSAP 2 (1971). This prompted its introduction into the EU Fourth Directive (1978) and hence into UK Company law via the Companies Act 1981[17]. Although these provisions of Company Law do not apply to IFRS accounts[18], the concept is also recognised in the IFRS Framework and in paragraphs 25 and 26 of IAS 1.

94. An Auditing Guideline issued by the Auditing Practices Committee in 1985, though ground breaking, was criticised in the late 1980's and early 1990's for advocating too passive a role for the auditor with respect to the going concern assessment. There was also no requirement for an active assessment by directors at the time – it was simply part of the consideration of the accounting policies. The DTI Inspectors appointed to look into the failure of Rotaprint criticised the auditors for failing to qualify their report in relation to going concern in 1991. In the same year, Mirror Group collapsed. In 1992, the APB's *Future Development of Auditing* called for a cultural shift in the audit regarding the going concern. In 1992, influenced by the Mirror Group collapse, the Cadbury Code was published and in 1994 the guidance for directors and auditors on going concern statements in accordance with the requirements of the Code and a new Auditing Standard on going concern (SAS 130) were all published. Going concern had become a stewardship and governance issue and an active consideration of the issue was required for this purpose by both directors and auditors.

95. It was the development of SAS 130 that prompted the insertion of active requirements for directors in relation to going concern in IAS 1. Similarly, when FRS 18 was published (2000), paragraphs 21 to 25 set out active requirements for the directors: to assess whether there are significant doubts about the entity being a going concern; if there are such doubts, to disclose them; to determine whether to adopt the going concern basis or another basis of accounting; and if another basis is adopted to disclose that fact and the impact on the financial statements.

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[16] Fremgen, 1968, *The Going Concern Assumption: A Critical Appraisal*, The Accounting Review and Zeff, 1999, The Evolution Of The Conceptual Framework For Business Enterprises In The United States, Accounting Historians Journal

[17] The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 and The Small Companies and Groups (Accounts and Directors' Report) Regulations 2008 specify the form and content of the accounts and directors' report of companies under Part 15 of the Companies Act 2006 where these are not prepared in accordance with international accounting standards

[18] IFRS accounts are required for certain groups under Article 4 of the EU IAS Regulation as set out in Section 403 of the Companies Act 2006.

96. These developments in accounting standards required an active consideration of the going concern issue by directors for purposes of the accounts. The outcome of that assessment determines first whether the basis of accounting should be the usual "going concern basis" or should be changed to the fundamentally different "break-up basis" (if there is no realistic alternative to liquidation) and secondly whether there are significant doubts about the going concern status of the entity and if so the disclosures that should be made. The accounting standards do not explain the purpose of the new disclosures so it is unclear whether they are intended to provide information to contextualise the accounting policies or to provide information in its own right about the economic and financial viability of the entity or both.

97. The Panel concluded from the comments received on the expectation gap that that there is a risk that there is not a sufficiently common understanding about either the threshold or the degree of conviction with which the going concern statement is required to be given or about the purpose(s) for which the assessment is made.

98. Accordingly, the Panel is recommending that the different language used in IAS 1, FRS 18, the Listing Rules, the Code and the illustrated application of the Code requirement in the Guidance for Directors should be reviewed and harmonised. In doing so, the dual purpose of the going concern assessment (see paragraph 96) should be made clear in relation to the requirements in the accounting standards. In relation to IAS 1 and the Listing Rules, the Panel is recommending that the FRC raises the issues respectively with the IASB and the UKLA.

99. The viability of a company's business model and the risks to its success are fundamental aspects of the stewardship and governance role of the directors. Investors and other stakeholders are more concerned about the robustness with which these matters are managed and governed than they are about the degree of certainty of the conclusionary statement about the future of the entity that the directors are required to make. The Panel believes that it is already clear that the purpose of the requirement in the Code and of the requirement in the Listing Rule derived from the Code 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. However, the panel recommends that the FRC should consider clarifying the purpose and making it explicit in the guidance for directors.

100. The Panel believes that the aim in requiring consideration 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 which 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.

Recommendation 2

The Panel recommends that:

a. **The FRC should seek to harmonise, and to clarify, the common purpose of the going concern assessment and disclosure process in the Code (and related guidance for directors and auditors) and in FRS 18 – and, in doing so, should reconsider whether the language of the provision of the Code, to the effect that the directors should state that the entity IS a going concern, is too definitive;**
b. **The FRC should engage with the UKLA to seek to maintain the existing congruence of the Code with Listing Rule 9.8.6 R(3), in light of these changes.**
c. **The FRC should engage with the IASB to seek amendments to IAS 1 to accord with the resulting position in the Code and FRS 18.**

Chapter 4 – What is the going concern assessment process?

Introduction

101. An overarching expectation that emerges from virtually all categories of respondents is that addressing going concern considerations is a fundamental aspect of the directors' stewardship of the entity and should be an integral part of the management of the business rather than a detached exercise carried out to support the preparation of the financial statements.

> *We do not operate standalone processes to assess going concern. The information used for the assessment is derived from the group's medium term plan as are the sensitivities and risks applied in the assessment. The assessment of going concern is undertaken at the half-year and full year Audit & Risk Committee meetings, including the supporting models and key sensitivities. As the going concern assessment is fully integrated within our normal business practices, it has not had any 'additional impact' on the management of the group.*
>
> *Corporate respondent*

The focus of the assessment – solvency v liquidity

102. Many drew the distinction between solvency risk and liquidity risk. Solvency is about longer term survival – avoiding the tipping point where debt and creditor liabilities exceed the value of the assets. However, liquidity is more relevant to the short term survival of the entity.

> *I believe that it is critical to draw the distinction between capital adequacy/ solvency and liquidity. … Capital may not always take liquid form, and it is possible for an organisation to be able to demonstrate that it is solvent i.e. has adequate available capital resources of sufficient quality to cover the required capital, but for the organisation to be constrained in terms of liquidity since the available capital is comprised of assets with low liquidity.*
>
> *Corporate respondent*

103. Investors generally think both are important and want to know that both are being managed effectively. However, many other respondents thought that for non-financial services entities the liquidity assessment was the primary concern and that solvency generally wasn't an issue.

> *It is important to distinguish between the long-term solvency of a company and its ability to survive in the relatively short-term. It is the latter which is normally the issue in the going concern question.*
>
> *Corporate representative body respondent*

104. Reconciling these two views is difficult. However, underlying cash generation is important to solvency (as well as to liquidity), as it underlies the economic value of the entity. A focus on the quality of underlying cash generation and of the factors driving it should at least contribute to an understanding of the long term value (and solvency) of the business, particularly if combined with a wider review of known and expected changes over the company's business cycle and of those risks that could bring the company down.

Focus and degree of conviction about solvency assessment

105. Investors and quite a lot of others have raised questions about the suitability of IFRS accounts as a basis for assessing solvency. There are broadly three views on the relevance of a balance sheet drawn up under IFRS or a similar framework to the going concern assessment:

- That the choice of accounting standards isn't very relevant outside the financial sector, because capital adequacy isn't generally a sensitive enough issue outside that sector. What makes the financial sector different is the greater exposure to asset value shocks. With high gearing these can quickly erode capital. In this sector, the regulatory capital assessment rather than the IFRS accounts is the better starting point as it is more prudent.
- An IFRS balance sheet isn't that useful for assessing capital adequacy because it lacks prudence. Proponents of this view think IFRS should be changed (some say the right changes – expected loss recognition and additional disclosure under IFRS 13 – are already being made, whereas others feel more fundamental changes are needed to bring back prudence into measurement and recognition).
- Capital adequacy can be assessed effectively based on IFRS accounts but this requires making adjustments for prudence to ensure that the measure of capital held is robust and able to withstand a reasonable range of stresses (e.g. through the cycle losses, or one-off losses).

The primary focus of IFRSs on decision-usefulness and the information requirements of investors may have reduced their ability to help shareholders and other users identify risks relating to going concern and liquidity.

Investor representative respondent

It was noted then that accounting attributes were moving away from prudence towards "neutrality" <u>and</u> allowing for loss deferral (not booking contingent liabilities or provisions), objectives which are in fact not only inconsistent with stewardship, but also making it difficult to identify if a company is in fact not a going concern when the accounts make it appear that it is.

Investor community respondent

We do not think that accounting balance sheets are necessarily very helpful informing a going concern view. The past is not necessarily a good guide to the future. … we note that the issue of providing for expected as opposed to realised losses has been the subject of much

discussion elsewhere and we would support some mild requirement for prudence to be introduced in this and other areas of reporting.

Representative organisation respondent

106. The Panel's view is that assessing solvency risk including capital adequacy is an important part of the going concern assessment for all entities not just those in regulated financial services industries. The search for risks that would affect solvency isn't expected to find and address all of them. However, it should look for critical risks in the business model and capital structure, should take account of past experience of economic cycles and the likely dynamics of those cycles for entities operating in its industry. It should also be alert to other macroeconomic developments (such as the likelihood of a credit squeeze, a major change in interest rates, or a serious return of inflation).

107. The solvency analysis looks out over a longer period than the liquidity analysis and is likely to be more qualitative.

108. Overall, capital management is important to investors – they want to understand how this is done, through the eyes of management. The IAS 1 disclosures are not generally providing what they want though they could in principle be used to do so. Many think that clearer views on definitions of capital are needed. Also, they want to hear what target ranges management have set for capital.

In the run up to the crisis investors considered that a number of companies omitted or provided boilerplate disclosures about their capital and did not communicate meaningfully how capital is assessed and managed. The information reported on capital needs to improve. For example, companies should clearly disclose what they regard as capital - whether it includes certain financial liabilities in that some companies include undrawn balances of long-term debt facilities in their definition.

Investor representative

It may be appropriate for further guidance to be issued on what constitutes capital, as it seems that individual businesses have a number of different practices and approaches.

Corporate representative

109. There was no comment in the evidence received by the Panel about management's understanding of the likely impact of their capital structure on their default risk, as perceived externally, and the implications this may have for their funding risk. The Panel considers this to be an important factor to consider.

110. A number of respondents commented on the question of the conviction with which the conclusion about solvency should be made and whether it is more or less than for a working capital statement. The working capital statement is for a definitive period of 12 months, whereas the going concern statement (and especially the considerations regarding solvency) are clearly over a longer period (a minimum period of 12 months). Against this,

being a longer term assessment it is likely to be inherently more uncertain and therefore perhaps made with less conviction.

Focus and degree of conviction about liquidity assessment

111. Whilst the focus here is on a shorter outlook period and is more quantitative than for the solvency assessment, it is also necessary to understand critical vulnerabilities in the medium term too.

112. Consideration of cash flow forecasts over a period of at least a year to 18 months is critical. The question that should be asked is 'How long can the entity survive without obtaining new funds or facilities on the basis of downside case cash flow projections? With the assumption of no new money, this exercise becomes quite similar to a working capital statement. Nonetheless, a number of respondents felt that even though the time frame was similar, the level of conviction required is rather less than for a working capital statement due to a variety of factors as set out in paragraph 66.

113. Where there is an anticipated renewal of facilities in the short term – say 12 to 18 months – it is important to consider what factors are relevant to renewal, such as:

- understanding likely renewal criteria;
- the relevance of the current macroeconomic environment relative to that prevailing at the previous renegotiation;
- credit rating needs if the company is reliant on market facilities such as a Medium Term Note or Commercial Paper facility.

114. Maintaining the availability of in-force facilities also needs to be considered – covenants and any other critical terms need to be considered and stress tested to assess whether compliance is feasible.

Going concern assessment – evidence as to current practice

115. There is a wide variety of current practice. The going concern assessment has traditionally focussed on cash and liquidity. The FRC guidance and recent experience have indicated that it also needs to take account of future profitability (as evidenced in forecasts and budgets). At the simplest level a company will prepare a business plan for the year and cash flow forecasts will be extended to a period of one year after the date of signing the financial statements. If the plans do not extend to this date, the auditor will disclose this fact in their audit report under ISA (UK and Ireland) 570: *Going Concern*.

116. In the Call for Evidence the Panel asked to what extent and how do directors assess the viability of a company over the course of its natural business cycle. A number of corporate respondents provided evidence that they monitor changes and trends over anything up to a five year period. The economic cycle plays a part in forecasting for some,

but the business cycle (the period over which profit is earned from the services or assets on which its business model is founded) does not appear to do so.

117. A number of respondents commented that the going concern assessment should be based on a 'through the eyes of management' approach.

118. Stress testing of assumptions was included in paragraph 45 of the Guidance for Directors as a tool to use in medium and large companies where sensitivity analysis indicates that there is a significant risk that the headroom between cash requirements and facilities available will be insufficient. The use of stress tests to ascertain just how far an assumption needs to vary before the company faces a going concern issue is a tool that has been used extensively in the financial services sector. Written evidence provided to the Panel suggests that using stress tests in such circumstances is a useful way of understanding the stresses that a company may face, given its business model, and could be used more extensively, not just in situations that look to be problematic.

> *Sensitivity analysis is a regular part of forecasting and budgeting procedures. We consider the impact of changes in key drivers of volatility as well as different strategic scenarios and consider the impact on operating results, cash flows and the Group's net debt position.*
>
> *Non-banking corporate respondent*

> *Stress testing as used by banks is little used by non-financial corporates in my experience. However I think there are lessons to be learned from the benefits that can be gained from such exercises and this may be usefully explored.*
>
> *Corporate respondent*

> *There are other more effective tools that could be employed across all industries such as running stress test and scenario analyses. … We would caution against publishing the results of stress tests as the results of hypothetical scenarios may be misinterpreted, but such analyses can provide invaluable insights into a company's resilience to its board and senior management team.*
>
> *FTSE 100 banking respondent*

119. Oversight of the process of making the going concern assessment is commonly undertaken by an audit and/or risk committee. However, the going concern assessment remains a responsibility of the board of directors.

> *We would emphasise that the oversight role of the audit committee is of critical significance.*
>
> *Investor representative respondent*

> *… audit committees are crucial in overseeing and being satisfied with the company's going concern status, liquidity and risk exposures, and with the quality and reliability of the company's reporting processes and output, including in particular the annual report and accounts and the company's accounting policies. … directors and the board as a whole have their own legal and fiduciary duties and responsibilities in this regard.*
>
> *Corporate representative*

120. Although it is not recognised in the Guidance for Directors, a number of financial services respondents commented on the importance of assessing the robustness of capital under stressed scenarios. While this is required for regulatory purposes in the financial sector, some assessment of the robustness of capital may be appropriate outside the financial sector too. Liquidity may also be dependent on the adequacy of capital resources.

121. Respondents felt that the work involved in reviewing going concern under a working capital statement would be similar to that performed for the annual assessment undertaken for accounting purposes. However, as noted above, the level of detail that the assessment will go into will be much greater. The working capital statement is a specific confirmation that the working capital is sufficient for present requirements, whereas the going concern statement in financial statements means that the directors have a reasonable expectation that the company will continue for the foreseeable future.

> *… in the case of raising capital the certainty that stakeholders demand is rightly far higher than that which they do in relation to general financial reporting. This has direct effect on the amount of work undertaken by the entity and the auditor/advisor, which in turn significantly impacts costs and fees. … this is ultimately a cost benefit question and we believe that shareholders would not support such an approach.*
>
> *Accountancy profession respondent*

Recommendation 3

The Panel recommends that the FRC should review the Guidance for Directors to ensure that the going concern assessment:

- **reflects the right focus on solvency risks, not only on 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 ;**
- **is more qualitative and longer term in outlook in relation to solvency risk than in relation to liquidity risk; and**
- **includes stress tests both in relation to solvency and liquidity risks that are undertaken with an appropriately prudent mindset. Special consideration should be given to the impact of risks that could cause significant damage to the community and environment, bearing in mind the directors' responsibilities under the Companies Act 2006.**

Chapter 5 – What should be the extent and nature of going concern disclosures?

Investor views

122. Investor respondents generally expect the financial statements to provide disclosure of significant risks to the going concern status of an entity and related information to enable them to assess those risks. They want to hear about these risks 'through the eyes of management'. This has two advantages to them. First, they believe this should provide a more tailored and perceptive analysis than would arise from rigid detailed disclosure requirements. Second, it should provide an opportunity to assess whether the directors are focused on the same issues that investors are concerned about. This in itself, they believe, could be revealing.

> *We would accept that some corporates may be poorer than others in eloquently explaining their judgments and risks; and that disclosures which could be termed as "boiler-plate" or bland are not helpful to the user. This needs to be addressed in order to provide shareholders and other stakeholders with the right information and not information simply for the sake of it.*
>
> *[We] firmly believe that the value in disclosure comes from it being made specific to the situation of the company and not from a standardised text.*
>
> *Accountancy profession respondent*

123. Investors contend that on-going disclosure of risks to a company's going concern status, focusing in each period on internal and external developments affecting the probability and incidence of those risks, would improve their own assessments and enable them to price the risks appropriately. With this information, they believe that the system of corporate governance and the markets would respond in an orderly and positive manner if circumstances were to develop such that those risks were heightened. This is less likely to be the case if the first the markets hear about such risks is when they have crystallised. Some said, for example, that they should never be surprised by a rights issue except where it is launched to fund an acquisition.

124. In effect, investors want better not more disclosures, more focus (from one place, ideally in the narrative report not the financial statements, with appropriate cross referencing) about the key issues for the specific entity (no boilerplate) that help confirm that the right issues have been considered by management. They therefore need to understand what management thinks are the key solvency and liquidity risks and why management thinks that they are adequately managed. A few investors had a contrary view, and thought that more disclosure would never be enough and therefore there was little point in trying – the market would anyway make its own assessments.

> *Companies, supported by the regulators, need to reconsider what information is of real importance to shareholders and present it more clearly to them. The emphasis is therefore on better disclosure rather than more disclosure.*
>
> *Investor representative respondent*

125. Investors accept there is a need for balance in disclosures, to avoid commercial damage to the entity, but generally they don't think this justifies failure to forewarn them of going concern difficulties, such as when a bank is in sufficient trouble to need central bank support. They believe the way to address the damage that arises from sudden disclosure of bad news is to be more open and proactive in disclosure in normal times as this builds greater trust between the investor and the directors of the company and may elicit a more proportionate response in bad times.

> *Identifying problems early enables remedial action to be taken sooner and invariably leads to a better outcome. Where disclosures are exceptional the reaction is emphasised.*
>
> *Meeting held with corporate reporting and accounting profession representatives*
>
> *… in our view, companies should be encouraged to give fuller and more transparent disclosures about going concern and to refer to "material uncertainties" and link the going concern and liquidity risk disclosures. If the users of financial statements had a better understanding of the meaning of those going concern disclosures and of the auditor's role in drawing the reader's attention to those disclosures this might encourage directors to be more transparent about going concern uncertainties.*
>
> *Accounting profession respondent*

126. The reluctance of directors to make going concern disclosures has been noted before and this is a key behaviour that impacts on a number of players. Auditor respondents recognised this reluctance, suggesting a number of contributing factors including that: a modified auditor's report in relation to going concern is interpreted as signalling a highly problematic going concern position; lenders, customers and suppliers overreact; other companies do not signal problems at a lower threshold.

127. Changing these perceptions about the impact of going concern disclosures is a long term issue. There was one suggestion that a statement by lenders and rating agencies, to the effect that the absence of any going concern disclosure would be taken, in itself, as a negative signal, might encourage more forthcoming disclosure.

128. Lending bank respondents generally felt that they did not rely solely on the information in the annual report, because any information about the entity's going concern status that was in the financial statements was generally reported too late to be useful to them. This sentiment was echoed by the credit rating agency commentators. They both rely on more detailed private information that they request which enables them to make their own forecasts. This resonates too with one commentator's suggestion that the real value in the publication of the banks' stress tests was not in management's own reported conclusions

but in the fact that it enabled market analysts to use the data to run their own stress tests and draw their own conclusions. In the case of lending banks and credit rating agencies, their relationship with the entity enables them to secure access to confidential data from the entity on condition that they do not publish it. Other stakeholders (particularly public company shareholders) do not usually obtain this degree of access.

129. In this context, one academic commentator suggested that entities should be required to provide public forecasts so that market agents didn't have to second guess them. The Panel believes that this would not be appropriate and would not be supported by most respondents as this would pose significant challenges in relation to the disclosure of proprietary and confidential information.

Other respondents

130. Other respondents' comments generally echo those of investors about wanting more focus, primary disclosure located in the narrative report with cross referencing to more detailed financial statement disclosures, and wanting entity-specific not boilerplate disclosures.

131. Some respondents thought that this would need to be integrated into the BIS narrative proposals and the Panel believes that the Strategic report would be an appropriate place for it.

132. One other respondent suggested there should be disclosure of major changes to the shape of the business that occur outside the planned strategy. The Panel also thought that changes of this sort should be disclosed, reflecting that sometimes these can develop in a creeping progression over some time until there has eventually been a major shift in emphasis to which attention should be drawn (e.g. a shift from 80% prime to 80% sub-prime mortgage origination).

> *For investors an understanding of the business model and its robustness will be crucial for allowing judgments to be made as regards long-term viability for the entity undertaking it.*
>
> *Investor representative*

133. There were some specific suggestions for improved disclosures, particularly around specific vulnerabilities – covenant terms (these are generally not disclosed publicly in Europe but are in the US market); maturity profiles for debt; intra month average and high/low balances for monetary balances; dependency on short term customer advances for liquidity; capital vulnerability to related party loans (especially owner/director loans in small companies).

134. Some also called for disclosure of alternative measures of capital (regulatory minimum capital, equity capital and distributable reserves).

135. The Panel believes that disclosure should be about the issues and risks identified in the process rather than primarily about the process. Process descriptions can rapidly descend into the generic and boilerplate, whereas a good description of the key issues can demonstrate a good process thus providing a sense of both. One investor – with considerable support from other investors at a meeting of the Panel with an investor group thought that this approach could be combined with a direct report by the auditor on the robustness of the process adopted.

> *We believe that some reassurance about the nature and extent of the scenario planning and stress tests to which the board subjects its business model, the key drivers of its balance sheet and cashflow statements, together with a description of the most important and volatile sensitivities, would be useful information.*
>
> *Investor respondent*

> *To improve the ability of investors and key stakeholders to assess a company's ability to cope with possible changes in key risks, we consider it appropriate to enhance disclosure of the results of stress testing of key risks and variables, such as exposure to interest rate and foreign currency movements, including disclosure of the maximum sensitivity movement which the company could withstand. This disclosure would allow investors a fuller insight into the sensitivity of the company to changes in its environment.*
>
> *Accountancy profession respondent*

Disclosing going concern and liquidity risks

136. Although the outcome of a going concern assessment is a binary decision, the considerations that make up this assessment are not binary and additional disclosure can provide stakeholders with relevant information about the risks.

137. Some believe there is an economic good attached to additional disclosures. For example, identifying a problem earlier may provide more time to resolve the issue. The alternative view is that such disclosures can lead to a quicker downfall for a company (a self-fulfilling prophecy).

138. It might be argued that if all companies were required to disclose the results of their sensitivity analysis, this might remove the self-fulfilling prophecy aspect of going concern reporting. However, a number of those who provided written evidence expressed concern about the commercial sensitivity of such information.

139. Disclosures may be accounting related, or more governance related, such as those associated with the company's business model. Therefore the disclosures associated with going concern and liquidity risks tend to be dispersed throughout the annual report.

140. In relation to the reporting model, the Panel notes that many called for better focus of the disclosures in one place, probably the narrative reporting – the message was better not more. This is in line with the proposals of the ECS work undertaken by the FRC. The

Panel believes that the going concern statement could be integrated with, and given in the context of, the proposed discussion of strategy and principal risks, with cross referencing to other relevant disclosures elsewhere in the narrative report or financial statements.

141. The Panel also notes the desire by investors to understand that the going concern process has been robust. The Panel believes that this could be achieved if the extended audit committee report envisaged under the ECS proposals[19] were to address the audit committee's review of the going concern process and related disclosures in the annual report, illustrating the effectiveness of the process through highlighting the key risks identified, how they were addressed and whether, and if so why, the directors are comfortable with any risks not fully addressed.

142. The evidence received suggests that there are behavioural disincentives for directors to make frank going concern risk disclosures, except in fairly advanced stages of distress, either as a result of: fear that disclosure may create a self-fulfilling prophecy; an overly optimistic outlook; or a degree of denial. Additionally, lending bank workout teams indicated that too much disclosure can be detrimental to the rescue process as some stakeholders may withdraw support, but early recognition and engagement by management with the issues will raise the likelihood of a successful turnaround.

143. The Panel has also considered whether the current requirements appropriately support what it believes should be the behavioural aims of the going concern assessment and disclosure process (see paragraph 100).

144. The current requirements are broadly as follows. The directors are required to make an active assessment of the going concern status of the company. They must use the going concern basis of accounting unless there is no realistic alternative to liquidation. They must disclose any significant doubts about the going concern status of the entity and the auditor should also signal these in their report. The directors of a listed company must make a statement that the company is a going concern, with supporting assumptions or qualifications if necessary. In addition, there are many other required disclosures given in the financial statements or elsewhere in the annual report that may be relevant to the going concern status of the entity. Directors are encouraged to bring the going concern related disclosures together in a single place or to integrate them through cross referencing.

145. The evidence submitted suggests that there are a number of ways in which the current requirements present barriers to these desired behaviours:

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[19] Under the ECS proposals (see: *Financial Reporting Council - Effective Company Stewardship: Next Steps – September 2011* at: http://www.frc.org.uk/images/uploaded/documents/ECS%20Feedback%20Paper%20Final1.pdf), the Audit Committee would report to the whole board and, after that report has been accepted by the whole board of directors, it would be published in full in the company's annual report.

Expectation gaps persist about when richer disclosures should be given about the going concern status (as discussed above) which can create uncertainty about the value of such disclosures, whether given or absent	The going concern assessment cannot provide a guarantee that the company will survive. Nor would there be any value to the process if it were only to signal failure when failure was virtually certain. Yet different descriptions of the threshold for richer going concern disclosures seem to create expectations anywhere between these extremes.
A high disclosure hurdle may create a perception that there is less need for a robust going concern assessment process and for stakeholders to understand the key risks and vulnerabilities, below this threshold	A high disclosure threshold for going concern (signalling significant doubts) may in effect give "permission" to directors not to undertake a sufficiently robust process or to make appropriate disclosures unless the entity's state of distress is very advanced.
The fear that disclosure of significant doubts will become a self-fulfilling prophecy of failure is heightened by a binary disclosure model	A company that suddenly signals that it is suffering significant threats to its survival risks stakeholders withdrawing their financial and economic support abruptly. This may exacerbate the company's difficulties and accelerate its demise. Fear of this outcome creates a climate in which directors are reluctant to disclose significant doubts.

146. The Panel believes these factors, acting together, create a climate in which directors are not appropriately encouraged to fully consider the going concern status of the company and to make informative going concern disclosures, other than in fairly extreme cases.

147. As a result, the Panel is recommending changes that would integrate going concern reporting with the ECS proposals – a move to a disclosure model in which the directors always report how they arrived at the going concern statement, as part of their discussion of strategy and principal risks in the company's narrative report, with the audit committee report confirming that a robust process has been undertaken and illustrating its effectiveness.

148. Such a reporting model may engender a greater openness between companies and investors. It would necessarily see a move away from the three category structure of disclosures[20], at least for directors. It may also be beneficial from a behavioural perspective in enabling investors and other stakeholders to be better informed on a 'business as usual' basis about key vulnerabilities (such as loan covenants) so that, when circumstances do deteriorate, a more proportionate response is forthcoming.

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:**
    - **confirming that a robust risk assessment has been made;**
    - **providing an explanation of the material risks to going concern considered and addressed; and**
    - **identifying any that they have not been able to resolve;**

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

[20] Under the FRC's guidance in *Going Concern and Liquidity Risk: Guidance for Directors of UK Companies 2009*, the disclosures in the financial statements which follow from the directors' conclusion about the ability of the company to continue as a going concern will identify three categories of company:

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

Chapter 6 – What should the role of the auditor be?

Auditing a going concern assessment

149. The level of work undertaken by the auditor seems to vary dependent on the level of risk associated with the going concern assessment. The work will involve examining systems and controls (e.g. budgeting, governance and treasury), analysis of the forecasts prepared, challenging assumptions and, in more complex cases challenging the degree of stress-testing undertaken.

150. ISA (UK and Ireland) 260: *Communication with those Charged with Governance* requires the auditor to communicate significant findings from the audit. In addition ISA (UK and Ireland) 570: *Going Concern* requires the auditor to communicate with those charged with governance events or conditions identified that may cast significant doubt on the entity's ability to continue as a going concern.

151. Auditors currently report on the going concern assessment made by directors as an integral part of their report on the financial statements and their review of other information. This involves three categories of report ('clean', emphasis of matter and disagreement). In practice, the latter category of report is rarely, if ever, seen. The sharp boundary between the other two categories, which coincides with the boundary between categories 1 and 2 in the going concern disclosures described above, means that entities have further disincentives to provide full disclosure on their risks.

152. Auditor reporting should reinforce the behaviours intended to be encouraged by the above proposals for the directors' going concern assessment process and reporting. If appropriate disclosures were always made by directors, the three categories of auditor report would not be needed as all annual reports would adequately disclose the directors' assessment of going concern.

153. The Panel believes that the auditor should comment in the audit report on the going concern section of the narrative report and of the audit committee's published report, if these fail to provide the required information, and otherwise state that it has nothing to add (see Recommendation 4). The Panel considers that this would be broadly consistent with the suggestion noted in paragraph 135 that the auditor should provide a report on the robustness of the process adopted by the directors.

> *Investors would welcome more assurance over how the directors have undertaken their assessment and that the assumptions are 'reasonable' in the context of the guidance. Ideally, auditors should explicitly report that they concur with the directors' assessment.*
>
> *Investor representative respondent*

Recommendation 5

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

- **consider moving UK auditing standards away from the three category model for auditor reporting to a statement in the auditor's report as to whether the auditor is satisfied that, having considered the directors' going concern assessment process, they have nothing to add to the disclosures made by the directors about the robustness of the process and its outcome; and**
- **seek to encourage the International Auditing and Assurance Standards Board to accommodate this approach in the International Standards on Auditing.**

Chapter 7 – Are banks special?

Introduction

154. There has been considerable analysis of the causes of the financial crisis of 2008[21], which spectacularly exposed the vulnerabilities of the banks. There has also been much discussion about why issues concerning the solvency and liquidity of certain banks were not flagged before their collapse in 2008[4].

155. The Panel has not set out to determine in any particular case whether forewarning of failure should or should not have been given. However, in view of the extent of the problems faced by the banks during this period, the Panel decided it was appropriate to consider the question whether banks and other financial institutions are fundamentally different from other companies in the non-financial sector and, if so, what should be the implications for their assessment of going concern and liquidity risks.

156. The Panel's approach to this issue was as follows. Whilst the Call for Evidence was not focused on any one industry sector, the Panel encouraged specific responses from those with experience of the financial sector. Eleven of the responses to the Call for Evidence were received from financial institutions and individuals who held senior management or governance roles at such institutions and the industry body for banks. In addition, 16 other respondents (especially investors and auditors) commented on the differences between banks and other entities. The Panel also held seven meetings with members of the banking regulatory community, a number of credit rating agencies and others with experience of the banking sector during the crisis and two meetings with groups of investors who commented on the position relating to banks. Finally, further evidence was obtained from published reports into the banking sector in the context of the crisis, where this was relevant to the going concern assessment.

What special survival issues do banks face?

157. The following extract from a description[22] of the circumstances in which Barings found itself in the 90's, illustrates some of the special survival problems that Banks can face:

"On Saturday November 8, … Barings disclosed its situation to the directors of the Bank of England. The problem now facing the Bank of England was the fear that if Baring's present situation were known to the public at large it would lead to not only a banking crisis but a drain of foreign capital from London. In order to avert this, both the Bank of England and the government decided to keep Baring's situation a secret. In addition to this, steps were taken to cater for any run by depositors on British banks or large capital flows out of London."

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[21] For example, *The Turner Review: A regulatory response to the global banking crisis* which was published in March 2009 and can be accessed at http://www.fsa.gov.uk/pubs/other/turner_review.pdf

[22] *Contagion Effects of Three Late Nineteenth Century British Bank Failures*, Ashraf A. Mahate, City University Business School, London – in Business and Economic History, Volume Twenty-three, No. 1, Fall 1994

158. The date was the 1890's rather than the 1990's. Baring's "situation" was not yet the Leeson affair but rather its uniquely heavy exposure to South American public authority and utility loans and other investments, built up over ten years to 1890 in a search for higher yields in the face of a low UK bank rate[23]. These investments suffered heavy impairment as a period of rapid economic development in South America suddenly stalled. The cash income streams from these assets dried up and the assets themselves became highly illiquid. Barings faced immediate cash flow shortfalls – its initial response was to cover its funding needs by borrowing from the London money market but as matters got worse it had to turn to the Bank of England for help.

159. On that occasion, Barings remained solvent and survived – based largely on its more prudent European and North American lending business – but needed a massive rescue to plug a short term funding gap[24]. Confirmation of its solvency was critical to Government support for a lifeboat being organised by the Bank of England.

160. A number of special problems related to a bank's survival, and their underlying causes, are alluded to in this example. These problems include fears of a run on the bank (a ***liquidity shock***) and fear of ***contagion effects*** leading to a wider banking crisis with consequential damage to the financial system and availability of capital. It also highlights ***the impetus for secrecy*** rather than transparency in these circumstances. It reveals fears of the ***impact of poor quality assets on the bank's solvency as the root cause of the funding crisis***, and that such fear is often born of once prudent lending principles compromised in a search for higher yields. Finally, it draws attention to potentially ***different Government attitudes to the rescue of insolvent as opposed to merely illiquid banks***.

161. All of these factors were arguably also evident in the 2008 crisis and indeed are common elements of many previous bank crises that have occurred internationally. They are not factors that generally affect other companies, including those in other sectors of the financial services industry. It is therefore important to understand why they are relevant to banks, how they operate and how they should be factored into the going concern and liquidity risk assessments of banks.

[23] During the period of 10 years from 1880 to 1890 Barings lent £30 million out of a total foreign lending of £100 million in the Argentine River Plate area – or, adjusting for inflation, £2.8 billion out of £9.4 billion in today's money. Inflation adjustment made by reference to the Bank of England Inflation adjuster at http://www.bankofengland.co.uk/education/inflation/calculator/flash/index.htm based on an inflation report at http://www.parliament.uk/documents/commons/lib/research/rp99/rp99-020.pdf

[24] £10 million or approximately £1 billion, adjusted for inflation – see footnote 23

How do these special survival issues for banks operate?

Maturity transformation

162. Money placed on deposit with banks by savers usually carries a right to repayment at short notice, often on demand. Banks channel these funds into long term loans and other investments. This financial intermediation process, known as maturity transformation, plays a crucial role in capital allocation in the economy[25]. However, it 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 creates an inherent instability in the bank's balance sheet.

163. Not all of a bank's funding comes from deposits. Apart from equity, which is permanent and loss absorbing, banks may obtain funds from other banks in the inter-bank markets or from bond and other securitised credit markets. Such sources may provide for longer term maturities than deposits but they are not permanent. Furthermore, although banks may arrange funding facilities with other banks, such facilities are not usually committed. Funding sourced from inter-bank and securitised credit markets is, in principle, therefore subject to the same maturity mismatch instabilities as deposits (albeit longer maturity dates may buy more time).

Solvency and gearing

164. The onset of a loss of confidence is most likely to be triggered by stakeholders becoming aware, often through rumour, of underlying issues in the bank's business, particularly issues that may lead them to question the solvency of the entity. Questions about solvency are therefore often the root cause of such a liquidity crisis. For example, speaking in October 2008, the Governor of the Bank of England said[26]:

    "When the financial turmoil began in August 2007, … the predominant view was that the crisis was one of (a lack of) liquidity. But, as time passed and markets [for some financial instruments] did not re-open, it became clear that the problem was deeper seated, and concerned the solvency of the banking system and the sustainability of its funding model."

165. Solvency concerns are particularly troublesome for banks' depositors and other lenders (as compared to stakeholders in most non-bank corporate entities) because banks are very highly geared and because they hold assets that can be volatile and therefore subject to asset value shocks. As a result, the equity buffer can be rapidly eroded by relatively small percentage reductions in the value of the bank's assets. Banks are not unique in having high gearing – this is a financing model found elsewhere (as in the venture capital/private

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[25] Lord Turner's speech *What do Banks do, what should they do and what public policies are needed to ensure best results for the real economy?* at CASS Business School in March 2010 – page 3. See: http://www.fsa.gov.uk/pubs/speeches/at_17mar10.pdf

[26] Speech by Mervyn King, Governor of the Bank of England to the CBI, Institute of Directors, Leeds Chamber of Commerce and Yorkshire Forward at the Royal Armouries, Leeds in October 2008. See: http://www.bankofengland.co.uk/publications/speeches/2008/speech362.pdf

equity industry) – what is unique is the combination of such high gearing with the maturity mismatch risks that result from the maturity transformation process.

166. Critical to confidence in a bank's solvency is the ***perceived*** quality of its assets. This is influenced (for example) by the perceived degree of prudence in its lending and investment policies, the incidence of external developments that may point towards possible asset value shocks and transparency about the bank's exposure to assets that may be adversely affected by such developments. Uncertainty about such matters, even if unjustified, may be sufficient to undermine confidence. This uncertainty may be idiosyncratic or system-wide. Action may be taken by an individual bank or by the regulators to address such matters[27].

Confidence

167. The stability of the bank's position depends on depositors and other lenders rolling over their deposits when they mature (remaining "sticky") or on other depositors or lenders replacing them. If existing and potential depositors and other lenders lose ***confidence*** in the bank, this rollover and replacement strategy fails, creating a run on the bank – current depositors seek to withdraw their deposits and new depositors are unwilling to replace them. The bank faces a ***funding shock*** and will fail if it is unable to liquidate its assets at a velocity sufficient to meet the demand for deposit and other loan repayments, when due and called for, even if it might be able to do so in full in the long run (ie even if it is solvent).

168. Once a run starts, it is usually self-sustaining – demand for repayment by some depositors creates a positive feedback loop that engenders similar demands by others, in a rush to get their money back before the bank's (presumed) limited liquid assets run out. Even with Government guarantees, depositors may want to avoid the delays that they may anticipate in recovering their funds through the guarantee scheme following insolvency. A run may be triggered and sustained with little official information, and even in the face of denials of the supposed problems, emanating from the entity.

Liquidity buffers and liquidity insurance facilities

169. The ability to withstand a liquidity/funding shock can be partially mitigated by the bank holding a certain level of highly liquid assets but if the loss in confidence is endemic such holdings will only ever enable the bank to delay the inevitability of failure that will ensue when these liquid resources run out. Furthermore, understanding the nature of these assets and what factors affect their liquidity is important to understanding what period of survival they might support in the event of a run.

[27] For example, in the financial crisis, the Treasury sponsored Asset Protection Scheme was instigated to address some of the more extreme long tail risks associated with some of the banks' assets. Other banks took action to bolster their capital by raising new equity.

170. A liquid asset is, in simple terms, one that is money or is readily convertible into money. For banks, their ultimate money is their "reserves accounts"[28] at the Bank of England. If an asset is anything other than money, its liquidity will depend on:

- a right to demand money from another entity (for example to demand money back from a money fund), which in turn depends on that entity's own liquidity when the demand is made; or
- on the ability to sell the asset in the market, which in turn depends on there being a liquid market with willing buyers.

Such liquidity cannot necessarily be relied upon even in normal times, let alone in a financial crisis when markets may seize and there may be system-wide liquidity problems for counterparties.

171. Banks can use their reserves accounts as a part of their liquidity buffer. They also have access to certain liquidity facilities[29] at the Bank of England. From the perspective of individual banks, these are essentially liquidity insurance facilities enabling banks to borrow sterling or gilts against high quality eligible assets as a means of managing a range of liquidity shocks. Like other central banks, as lender of last resort the Bank of England may provide ELA to individual banks that are experiencing extreme liquidity difficulties, in order to prevent a loss of confidence spreading through the financial system as a whole.

Contagion effects

172. When depositors and other lenders lose confidence in one bank, there is a risk of this loss of confidence spreading to other banks, fuelled by fear that the same underlying problems could be affecting other banks. Once acted on by some depositors, it can rapidly take hold and lead to a general run on the banks.

173. The extensive use of domestic and international inter-bank funding also creates a web of interconnection between banks that may exacerbate these contagion risks, particularly if combined with uncertainty about the impact of asset value shocks on individual banks through a lack of transparency. Inter-bank lending exposes creditor banks to the

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[28] Reserves accounts are effectively sterling current accounts for commercial banks - they are among the safest assets a bank can hold and are the ultimate means of payment between banks. Whenever payments are made between the accounts of customers at different commercial banks, they are ultimately settled by transferring central bank money (reserves) between the reserves accounts of those banks.
See: http://www.bankofengland.co.uk/markets/money/reserves/index.htm

[29] These currently include Operational Standing Facilities (effectively sterling cash deposit and overdraft facilities for banks); Indexed Long-term Repo (facilities to borrow sterling cash against eligible securities, accessed by auction); and the Discount Window Facility (facility to borrow gilts to cover idiosyncratic as well as system wide liquidity shocks). See: http://www.bankofengland.co.uk/markets/money/index.htm and http://www.bankofengland.co.uk/markets/sterlingoperations/summaryops.pdf Under the Special Liquidity Scheme introduced in April 2008, banks and building societies were able to swap their high quality mortgage-backed and other securities for UK Treasury Bills for up to three years. There was aggregate take-up of some £185 billion, which will unwind over the three year period of the scheme. See: http://www.bankofengland.co.uk/markets/sls/index.htm

underlying risks of debtor banks. The implications of secondary exposures to poor quality assets through such lending are important both for individual banks and for the stability of the financial system as a whole.

The impetus for secrecy

174. Where a bank's directors anticipate problems that may trigger a run, the risks to its survival may create a moral dilemma: against their duties to maintain market transparency, they may weigh the almost certain knowledge that disclosing the bank's true position (including its reliance on Government support or ELA) externally will trigger the failure of the bank as a whole. This creates an impetus for secrecy whilst they seek to resolve the issues.

175. Banks play a number of systemically important roles in the financial system, which underpin the health of the economy[30] – as a result, society has a significant interest in their survival and they are heavily regulated. There is an obligation for directors of banks to bring survivability issues to the attention of their regulators. The systemic impact of a bank's failure is primarily a concern and responsibility of the bank's regulator. Regulators may face the same 'secrecy' dilemma as directors – whether to keep the support secret whilst the problems are being addressed, having to carefully weigh the potential systemic consequences against the public interest case for disclosure, even to Parliament. For example, the Bank of England provided ELA to RBS and HBOS, primarily during the last quarter of 2008. In that instance, the Bank of England judged that it was appropriate to keep details of that assistance secret for a little more than a year.

176. Whether secrecy is appropriate in these circumstances is a matter of public policy. It is recognised that maintaining secrecy may not be easy, given that a number of players may have obligations to disclose the information or information from which such support may be deduced by the markets (see below). The circumstances surrounding the run on Northern Rock in 2007 illustrated the consequences that can arise when secrecy is not maintained. Some derogations from normal disclosure obligations have been instituted for this reason – for example:

- the bank or its holding company – obligations to disclose 'inside information' under the FSA's Transparency and Disclosure Rules may be delayed in relation to ELA in certain circumstances[31]; and obligations to include charges over a bank's assets in its

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[30] These include the provision of payment services (both retail and wholesale), the maintenance of financial markets and financial intermediation between savers and borrowers and between investors and businesses. Lord Turner's speech *What do Banks do, what should they do and what public policies are needed to ensure best results for the real economy?* at CASS Business School in March 2010. See: http://www.fsa.gov.uk/pubs/speeches/at_17mar10.pdf

[31] 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." 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

register of charges and to register them at Companies House are not applicable in relation to charges granted as security for ELA[32];

- the Bank of England –has the power to limit disclosure of information in its accounts in certain circumstances, to the extent it considers it appropriate having regard to its functions, and did so in relation to the 2008 ELA provided to RBS and HBOS[33];
- the Treasury – if a Government guarantee is given in connection with the ELA, there are longstanding arrangements that acknowledge a public policy acceptance of the need for confidentiality and disclosure of the contingent liability may be delayed for a period of time, in certain circumstances, subject to confidential reporting (at least orally, following a discussion by the Treasury Select Committee in 2009 of the delayed disclosure of the RBS and HBOS ELA) to the Chairmen of the Treasury and Public Accounts Committees.

177. Disclosure that a bank has received ELA is widely recognised to be potentially relevant to investors, markets and other stakeholders. It was in that context that DTR 2.5.5A R [31] was introduced into the FSA's Disclosure and Transparency Rules, to allow banks in certain circumstances to derogate from the strict rule on disclosing inside information to the market. The Panel notes that there are no similar specific derogations from: the requirements of Listing Rule 9.8.6 R (3) for the directors to make a statement about the going concern status of the entity; the disclosure requirements of the Listing Rules applicable to Prospectuses and other Circulars to shareholders (although there is a general derogation in the Prospectus Rules where disclosure would not be in the public interest[34]); or the requirements of the Companies Act (or other similar requirements applicable to some financial institutions) to publish financial statements that give a true and fair view.

The consequence of severe distress

178. Once confidence has been severely undermined, failure may be inevitable without some form of major intervention even if the bank is still solvent – in the Barings case referred to above the solution was a lifeboat, sponsored by the Bank of England, under which Rothschild and other city institutions provided commitments to fund the huge liquidity

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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 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).

[32] Section 252 of the Banking Act 2009 provides that Part 25 of the Companies Act 2006 (Company Charges) does not apply if the person interested in the charge is the Bank of England, another central bank or the ECB.

[33] See Additional information provided to the Treasury Committee by the Bank of England – Tuesday 24 November 2009 at: http://www.bankofengland.co.uk/publications/other/treasurycommittee/financialstability/ela091124.pdf and the Bank of England Annual Report 2010 (Page 3 – Foreword by the Governor) at: http://www.bankofengland.co.uk/publications/annualreport/2010report.pdf

[34] See the FSA's Prospectus Rule PR 2.5.2 which is founded on Section 87B(1) of the Financial Services and Markets Act 2000

gap that Barings faced. In today's world, a bank approaching these difficulties would likely be subject to intensified regulatory intervention by the FSA[35] working closely with the Bank of England and HM Treasury when necessary.

179. This may lead to a wide range of actions being taken. It may prompt the bank to seek access to ELA from the Bank of England as lender of last resort (see paragraph 171). 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.

180. A bank's entry into the SRR is triggered by the FSA when it decides that a 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. The threshold conditions are those that must be met to obtain its banking licence and include amongst others that it has sufficient liquidity and capital resources.

181. The conditions under which such referral should occur is set out in the Banking Act 2009, Section 7, sub-sections (2) to (4)[36]. In effect, these conditions mean that reliance on Government support or on other than ordinary market assistance by the Bank of England (ELA may or may not be ordinary market assistance depending on the facts), without which the bank would, or would be likely to, fail to meet the FSA's threshold tests – would normally result in the bank being referred to the SRR.

182. 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*). Stabilisation tools include:

- the power to transfer some or all of the assets and liabilities of the bank either to a private purchaser or to a bridge bank owned and controlled by the Bank of England or to transfer some or all of the shares of the bank to a private purchaser (the *transfer tool*); and

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[35] Under the proposals set out in the FSA's Consultation Paper CP 11/16 – Recovery and Resolution Plans, the bank might also breach triggers requiring the implementation of its Recovery Plan. See: http://www.fsa.gov.uk/pubs/cp/cp11_16.pdf

[36] (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).

- the power to transfer some or all the shares of the bank, or of a holding company of the bank, to a nominee of the Treasury (*Temporary Public Ownership*).

Evidence from responses received and through meetings

Differences from other entities

183. A wide range of respondents commented that Banks are different from other entities, including from other financial services entities, largely due to the intensity of their solvency and liquidity risks. One respondent suggested that this makes it difficult to have 'one size fits all' guidance though many others were content that the Guidance for Directors was a useful framework for banks as well as other entities.

184. They referred to the importance of confidence, the impact of maturity transformation and the need to rollover short term funding. Several also noted the interdependence of banks so that the stability of the whole banking system is also important to each bank's survival and it is therefore difficult to assess solvency and liquidity risks in isolation from other banks. Credit rating agencies confirmed that, looked at objectively compared to many non-banks, the banks' liquidity models are inherently weak and that banks' credit ratings are typically set several notches higher than they otherwise would be if it were not for the assumption of implicit Government support. One respondent commented that the general absence of loan facilities with covenants means that Banks are not subject to the external monitoring disciplines that such covenants bring.

185. Many mentioned that public signalling of significant going concern problems – either by the directors or through the auditors issuing an emphasis of matter paragraph – would pose an immediate threat of a self-fulfilling cause of collapse. It was suggested that, as a result, auditors and directors would have significant disincentives to do so. In this context, the importance of an open, cooperative and constructive relationship between the auditor and supervisor is widely recognised and the FSA's recently published Code of Practice[37] for auditors and supervisors was welcomed as a significant step in reviving confidence in those relationships.

186. Another major difference noted by many is that Banks are subject to regulation. Regulation sets minimum requirements for solvency and liquidity that are meant to provide buffers against shocks. The going concern assessment was characterised by many as a highly judgmental forward looking process that required a principles based rather than a rules based approach. Regulatory minima should not be seen as rules. They should not replace directors and others' judgments. Directors should live and breathe these issues.

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[37] FSA Final Guidance: *Code of Practice for the relationship between the external auditor and the supervisor – May 2011* – see: http://www.fsa.gov.uk/pubs/guidance/fg11_09.pdf

187. Following the crisis, there is a wide range of reforms that have been and are still being introduced that are relevant to banks' consideration of the going concern assessment and the Panel was urged to consider their impact. 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[38] (which will require new disclosures based around funding rather than cash flows); the Basel III accord which proposes a number of changes, including to minimum capital requirements and liquidity risk management and disclosures; the introduction of the Special Resolution Regime – see paragraph 178; the move towards the development of individual bank Recovery and Resolution Plans[39] (so-called 'living wills'); the proposed Proactive Intervention Framework proposed for the Prudential Regulatory Authority[40]; and the recommendations of the Independent Commission on Banking[41].

188. Another view expressed was that the crisis had laid bare real concerns about the inherent difficulties in making risk assessments at the biggest and most complex banks due to the size of their balance sheets, their business complexity, the geographical spread of their operations and the intrinsic uncertainties in some of their balance sheet items. With few exceptions, it was thought that large banks do not prepare consolidated risk assessments. There are investors who see such complexity and the resultant volatility as trading opportunities. It was also thought that banks are better placed to 'manage' their balance sheets around reporting dates (***window dressing***) than are many other entities.

Comments about the assessment process for banks and lessons learnt

189. The going concern assessment process is not considered to be different, in principle, for banks as compared with other entities. The importance of assessing risks to both solvency (including capital adequacy) and liquidity are and always have been widely recognised and embedded in banks' processes. Banks who responded said they have made significant changes to enhance their going concern processes in light of the experience of the financial crisis – some to respond to the more intense shocks experienced and some to respond to the regulatory reforms that have been and are still being introduced.

190. These changes include building into their processes more stress testing and changes to reflect changes to the capital adequacy and liquidity management regulatory requirements and that they have put more focus on the governance of both risks and the going concern assessment. Reverse stress tests are also now part of the process. They involve identifying

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[38] See: http://www.fsa.gov.uk/pubs/policy/ps09_16.pdf

[39] FSA proposed rules for Recovery and Resolution Plans are set out in CP 11/16 – see: http://www.fsa.gov.uk/pubs/cp/cp11_16.pdf

[40] 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

[41] The final report of the Independent Commission on Banking can be found at: http://bankingcommission.s3.amazonaws.com/wp-content/uploads/2010/07/ICB-Final-Report.pdf

what could make the bank fail and then considering whether such a scenario could realistically occur.

191. Capital adequacy and liquidity risks are separate – shocks to one can arise even when the other is stable. Key lessons learnt about liquidity risk are reported to include the need to be able to service a credit default, the illiquidity of a major asset class and the loss of access to new finance.

192. Many mentioned that in relation to solvency assessments, the going concern assessment is a forward looking process; whilst it builds on past data, it also includes looking at possible outcomes not yet experienced. This does not sit well with the IFRS accounts which are essentially backwards looking. Many considered that banks should consider risks to their solvency over the business cycle and many thought this was primarily done through development and review of a three to five year business plan. The twelve month time horizon is too short in this respect, at least for banks. The assessment should also identify and address the implications of changes in the business model, not only major strategic changes but also others that may have evolved over some time.

193. The business cycle might be different for different banking operations – for example, trading banking has shorter and more severe cycles. Where the revenue earning cycle is longer than one year, there may be unrealised profits recognised under the accounting rules which remain at risk but may be distributed. Under the Basel III reforms there are some solvency triggers that would limit dividend pay-outs.

194. There was a wide range of respondents and commentators who felt that the neutrality of IFRS financial statements is, particularly for banks, not suited to going concern assessments and that a more prudent mindset was required.

195. Some even questioned whether a separate financial reporting and auditing system is needed for banks in this context. One commentator suggested a combination of factors that make banks (and possibly other finance companies) sufficiently unique to warrant considering this idea further:

- The complexity of their portfolios and the uncertainty of value of that portfolio, together with their high degree of reliance on automated systems to manage and record their business, are particularly important from an auditing perspective and could justify separate auditing rules for banks;
- The current approach to these uncertain values in balance sheets (with a primary focus on point estimates) does not reflect the fundamental importance of that uncertainty to the business models of banks – a key role of financial markets is to price that uncertainty and banks' accounts might do investors and other users a greater service if they more effectively recognised and, where possible, quantified those risks;
- There may be a greater need for metrics in banks' accounts that lean against a greater inherent capacity to 'window dress' their financial position;

- In addition to the above factors, the complexity of the structure of banks, and of the instruments they invest in, pose particular challenges for making transparent and meaningful disclosures – banks can seem a black box, including for many investors, into which the accounts shed little light;
- The going concern issue is far more judgmental than for other companies – one critical factor here is the volatile impact of liquidity risk and its dependence on market confidence as much as balance sheet values;
- The impact on that confidence of a bank "failing" a binary pass/fail going concern reporting model (either through the directors or auditors signalling significant uncertainties) creates a strong positive feedback loop for liquidity stress; and

Taken together, these factors suggest that a more graduated model for going concern reporting would be appropriate for banks.

196. The incurred loss model is widely accepted to have been inappropriate and is being addressed. A number of respondents and commentators suggested that there was a sense that IFRS engendered a compliance mentality and that a more principles based approach was appropriate. The behavioural risk with a rules based system is of management trying to be just the right side of the line. Some welcomed the recent statement from the FRC pushing back on this notion and reconfirming the continuing primacy of the true and fair requirement and its relevance to preparers, those charged with governance and auditors[42].

197. A number of investors raised specific concerns about the consolidation of Master Trusts[43] into the balance sheets of stand-alone legal entity accounts of banks under IFRS. They believe that this practice resulted in capital in those trusts being treated as equity of the bank and that this masked the risk of a 'margin call' under covenants granted to the trust by the sponsoring bank.

198. Others noted that, although there are disclosure requirements for capital management, there is no definition of capital and widely different measures are reported in practice.

199. The effective governance of risk and the going concern assessments was raised by a number of respondents and commentators. Banks need to take risks but there should be an appropriate degree of investigation and reporting of such risks. The role of governance should be to challenge with scepticism, leaning against the natural optimism of management, but recognising that all risks cannot be eliminated.

[42] *True and Fair*, published by the Accounting Standards Board and APB in July 2011 can be found at: http://www.frc.org.uk/press/pub2605.html

[43] A mortgage-backed securities Master Trust is a structure for collateralising a revolving pool of mortgages for the benefit of those parties who have a joint interest in the trust property. See also: *Re-visiting UK mortgage master trust structures* – (William Howard Davies and Ganesh Rajendra – Deutsche Bank – 2008) at http://www.globalsecuritisation.com/08_GBP/GBP_GSSF08_161_166_DB_UK_Mort.pdf

Comments about going concern disclosures by banks

200. In common with more general comments received, many respondents and commentators believe that going concern disclosures by banks should be less dispersed, more focused (better not more), more holistic, integrated with the discussion of risks and should reflect a fair and balanced view on the risks to the going concern status of the bank.

201. It is widely recognised that banks are already subject to greater disclosure requirements than other entities under IFRS, through the Basel II Pillar 3 requirements. IFRS has limited capital disclosure requirements – for example no sensitivity analysis is required and there is no requirement to disclose capital ratios. Some banks give additional voluntary disclosure and the British Bankers Association Disclosure Code plays a role here. Examples of voluntary disclosures include regulatory capital ratios, exposure to certain Eurozone countries' debt, details of the liquidity pool, term funding arrangements and the leverage position.

202. One area of concern to regulators is the inconsistency they observed in valuations of the same financial instruments using different models. Whilst recognising that differences may be inevitable under IFRS, there are inherent issues with point estimates. More disclosure of valuation uncertainty might help in this area and work is being done to develop a model for such disclosure. One commentator had reservations about whether point estimates are the best way to describe the value of assets which have a wide range of outcomes and questioned whether it might be possible to provide richer information by adopting a more probabilistic description of such items – as for example is done in some actuarial analyses for insurance risk best estimates.

203. In relation to the (often questioned) lack of forewarning of impending problems for banks that failed in the crisis, many said that in at least some cases the risks were fully disclosed. In this context, another commentator suggested that disclosure of the risks is not in itself enough – and that what is needed is an explanation why the directors are comfortable with the risk.

204. It was noted that the European Banking Authority publishes its stress tests but there is no requirement for banks to publish the results of their individual bank standardised regulatory or 'own-rolled' stress tests. There is some support for regulators publishing the results of standardised stress tests for capital adequacy, as long as adequate explanations and context are provided. However, many banks who responded drew attention to their concerns about the same being done with liquidity stress tests proposed under Basel III. Their main concern is that such disclosure may create pro-cyclical pressures for counterparties to withdraw and not renew funding as the stress points are approached.

205. A number of commentators stated that Government support and ELA from the Bank of England indicate difficult circumstances and that this should be disclosed publicly. However another view was that there may be times when such disclosure could damage financial stability and might not be appropriate.

206. There were a number of suggestions for possible additional disclosures:

- The types of scenarios taken into account in the directors' assessment
- Disclosure by the audit committee of what could cause the bank to fail
- Reporting of period average and period high and low balances not just period end balances
- More disclosure about liquidity (eg the number of days the bank can continue operating without new funding)
- Leverage
- The bank's most risky assets and what the expected losses might be
- Disclosures that emphasise inherent limitations in the assessment process
- Clear disclosure of the bank's business model and of its risk profile, identifying a focused set of primary and important markets and risks.

207. A number of respondents cautioned that disclosures are not necessarily the best way to change entity behaviours. They say that some current disclosures are not being widely used by investors (eg Pillar 3 disclosures and the European Banking Authority stress tests, other than to update their models) – in many cases, additional information was provided to regulators about risks and exposures but this did not necessarily change underlying entity behaviours.

Questions about the role of auditors of banks

208. There were a number of questions raised for auditors of banks:

- Were auditors too passive, providing less challenge, under IFRS?
- Do auditors understand where management is on the optimism scale and the extent of challenge in the risk and going concern governance processes?
- Is sufficient attention paid to stress tests – real value is perceived in auditors assessing whether the company has done enough in this area and whether there has been enough challenge in the process?
- Are there sufficient people with the right depth of experience in banking to properly service bank audits?
- Do auditors take sufficient account of the market situation when considering capital adequacy – is it at the top of a cycle?
- Do auditors have a good understanding of the business model and its risk profile and of the prudential practices of the banks?

Evidence from published reports into the banking sector

209. The Panel identified three published reports that addressed the banking sector in the context of the crisis and contained evidence relevant to going concern assessments of banks. Key findings of those reports are summarised below.

The Valukas report on Lehman Brothers Holdings Inc[44]

210. Lehman's business model was similar to other investment banks: a high-risk, high leverage model which required the confidence of counterparties to sustain it. Assets were predominantly long-term, while liabilities were largely short-term. In 2006 Lehman embarked on an aggressive growth strategy which increased its risks and leveraged its capital more extensively. This strategy was directed by senior directors and Lehman's net assets increased by almost 48% between Q4 2006 and Q1 2008, primarily as a result of the accumulation of illiquid assets that could not be sold easily in a downturn. The management did not amend risk controls to take account of this new business strategy: stress testing was not applied to un-traded assets and once it was, results were not shared with senior management. If anything, controls were relaxed in order to facilitate the strategy (for example, risk appetite limits were increased for 2007 and 2008 and single transaction limits were not imposed).

211. The directors fully supported the growth strategy, knowing that this would increase the risk appetite of the firm. The bank did not recognise the impact that the sub-prime mortgage business would have on other business lines: when problems started to occur, the board made a conscious decision to continue with its strategy, hoping to profit from a counter-cyclical strategy. Lehman was the most aggressive lender per dollar of shareholder equity in early 2007. Although senior officers believed that Lehman did not have the balance sheet to support such business, it proved difficult to curtail the commitments made to business expansion and in mid-2007 Lehman was reporting deteriorating liquidity and capital adequacy internally (although no such reports were made to the board). In late 2007 and early 2008 Lehman's focus was on selling assets to improve net leverage although this was difficult as these assets had now become 'sticky'.

212. Following the near collapse of Bear Stearns in March 2008 Lehman's survival was in question and moves to raise further capital were commenced. In order to buy more time "Repo 105" transactions were used to reduce the net leverage ratio reported, suggesting a strong and robust liquidity pool. These transactions were treated as sales of assets although in fact there was no business reason for these transactions, except to reduce the balance sheet totals. They were more truly financing transactions, although the accounting had been carried out correctly. By June 2008 significant components of Lehman's liquidity pool had become difficult to monetise. Lehman was unable to retain the confidence of its lenders and counterparties when it became public that attempts to form strategic partnerships had failed. As a result of reporting two quarters of significant losses, a concentration of illiquid assets and no definitive survival plan, Lehman was unable to meet its current obligations and sought Chapter 11 protection in a bankruptcy proceeding on 15 September 2008.

[44] Lehman Brothers Holdings Inc. Chapter 11 Proceedings Examiner's Report published in March 2010 can be accessed at: http://lehmanreport.jenner.com

The Nyberg Report into the causes of the systemic banking crisis in Ireland[45]

213. A systemic crisis such as this requires a great number of people to follow unsound practices or policies and responsibility is spread widely. This report looks at what the most important policies, practices and linkages were.

214. The willingness of banks to accept higher risks by providing more and larger loans, primarily for commercial property, was an important reason for the financial fragility in Ireland. Anglo Irish Bank in particular grew strongly by providing loans to riskier parts of the property market and was seen as a role model for other Irish banks. This led to lower credit standards and traditional risk evaluation procedures and risk mitigants were not implemented. Neither banks nor borrowers understood the risks they were taking and governance fell short of best practice.

215. Loan growth was funded by the wholesale market as there was insufficient growth in customer deposits. This made them much more vulnerable to any doubts about their own solvency or that of their borrowers as wholesale funding is more volatile than customer deposits. Market share and profitability were sustained by a self-reinforcing spiral: both demand for loans and prices of property increased and accounting standards did not suggest more prudent provisioning. However, as bank funding dried up in 2007, the sector experienced liquidity problems and this led to a downward trend in prices and demand.

216. Minority views had been difficult to maintain during the boom and conformity of views reduced the need to monitor what was going on. There was a 'herding' mentality amongst banks which followed others with little critical analysis of the risks and advantages. Not being able to match the profitability of Anglo Irish Bank was thought to be a weakness that could lead to a decline in value and potential takeover. The Financial Regulator was aware of many of the problems and highlighted its concerns, increasing minimum capital ratios in the banks concerned, but this did not ensure greater prudence and accountability.

217. Issues of credit quality, sustainable lending practices and internal procedures were not commented on by the auditors. This is thought to show that the auditors were concerned primarily with the accuracy of the historic accounts, meaning that they look backwards and at technical issues, rather than at issues such as these which are seen as outside their remit.

218. One conclusion was that poor governance will inevitably lead to a poor quality loan book and/or instable funding, but going concern issues are likely to come to the fore before this is highlighted as a result of liquidity problems.

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[45] Misjudging Risk: Causes of the systemic banking crisis in Ireland – report published by the Commission of Investigation into the Banking Sector in Ireland in March 2011 – see: http://www.bankinginquiry.gov.ie/Documents/Misjuding%20Risk%20%20Causes%20of%20the%20Systemic%20Banking%20Crisis%20in%20Ireland.pdf

House of Lords Select Committee on Economic Affairs on Auditors

219. Statutory audit is largely backward looking, but does include a view that the company remains a going concern, which is sometimes taken as a forecast of good financial health. Such misunderstandings have created an 'expectations gap'. Critics who do understand the role of the audit have advocated more emphasis on the going concern statement, which is the only forward-looking element in an audit report.

220. Sir David Walker recommended that FTSE 100 financial services companies should have a risk committee, which is separated from the audit committee and has responsibility for capital and liquidity management.

221. The House of Lords report recommends that the vital role of prudence and the importance of the going concern statement should be emphasised in audits. Going concern in a bank is inextricably linked with a question of confidence. However, it was thought that this confidence should not be rooted in the understanding that banks in difficulties would be bailed out by the authorities.

222. In 2006 Northern Rock was operating a risky business model and the FSA noted differences in this business model compared to its peers. PwC reporting concerns about Northern Rock to the FSA in September 2007 and emergency support was granted. However, other banks were still funding themselves in the short term wholesale markets at the end of 2007 and auditors did not believe that a going concern qualification was appropriate.

Conclusions in relation to banks

223. The Panel considered whether banks and other financial institutions are a special case. Banks, but not necessarily other financial institutions, are certainly different from most other types of business in relation to the intensity of their going concern risks. They have high solvency risks because they are very highly geared and they hold assets that are subject to asset value shocks which can quickly erode their relatively thin capital. They also have high liquidity risk because the process of maturity transformation creates mismatches between maturity dates of their assets and financial debts. They are therefore exposed both to solvency and liquidity shocks. Furthermore, concerns about their solvency, when they arise, can precipitate liquidity shocks. In short, their business model is fragile and built on the confidence of those who fund them with short term money. The Panel concluded that banks therefore need to have a particularly intense focus on the going concern assessment.

224. For the same reasons, banks are heavily regulated and following the financial crisis there are a number of on-going initiatives to damp down their risk taking, to increase their minimum regulatory capital levels, to improve their resilience to liquidity shocks, to ensure they undergo and report regularly on stress tests and to make it easier for them to recover from shocks and to be resolved in the event of failure by developing recovery and

resolution plans. The responsibilities of the directors of banks are not simply met by placing reliance on the minimum regulatory benchmarks, but by being on top of their going concern assessment all year round, by living and breathing it.

225. A bank's auditor also needs to address its work in this area at as early a stage as possible. The special factors at play in banks and the intensity of regulatory requirements imposed on banks (as to minimum levels of capital and liquidity resources, as to processes for the management and governance of solvency and liquidity risks and for reporting to the regulators on the status and level of such risks) mean that the auditor needs to be expert in these matters as well as fully understand the business model of the bank, which may itself be highly complex. Considerable lead time is needed to make its own critical assessment and to follow through if any serious and imminent risk is identified, including raising the matter with the bank's supervisor.

226. Early and open communication between directors, auditors and regulators will provide the greatest possible chance for co-ordination and sharing of information about stresses being experienced and solutions being developed. This is vital to the auditor developing a proper understanding, and making a critical assessment, of these matters and should contribute to the knowledge of the regulatory authorities. Such co-ordination should limit the opportunities for communications to the market to undermine confidence and bring the bank down prematurely. The Code of Practice[37] for auditors and supervisors signals the importance of these channels of communication being familiar and effective in both normal and troubled times.

227. One particular issue that has been widely debated recently is the extent of disclosure, both by banks and their auditors, where a bank relies on Government support, ELA or liquidity insurance more generally from the Bank of England. Such support may be a critical factor on which the bank's survival depends, in some difficult circumstances. Untimely disclosure of such support could damage confidence in the bank. Nonetheless (as discussed in paragraphs 176 – 177) despite the understandable desire for secrecy from the perspective of preventing unnecessary failure and damage to the financial system, maintaining secrecy may not be easy, given that a number of players may have obligations to disclose the information or information from which such support may be deduced by the markets, despite the existence of some derogations. As a result, difficult decisions may have to be made about the extent of disclosure, both by banks and their auditors.

228. The Panel believes that directors' and auditors' approach to this issue should articulate appropriately with the escalation of supervisory intervention: from identifying emerging stresses that need to be reported to the regulator; to the need to trigger actions to recover from those stresses (including reliance on liquidity insurance); to the need to acknowledge that the bank is not likely to survive as an independent going concern and that a resolution is required; and, ultimately in exceptional circumstances, to the need for the supervisor to trigger the provisions of the SRR. A common understanding and approach to the going concern status for a bank supports appropriate co-ordination between

auditors, directors and regulators and provides directors and auditors with a framework for analysing potential going concern disclosures that may be necessary to meet the requirements of accounting standards, Company law (as to accounts giving a true and fair view), and the requirements of the Code and of Listing Rule 9.8.6 R (3).

229. It is the FSA (with the advice of the Bank of England and HM Treasury) and not the auditor that has to decide whether to refer a bank into the SRR. If the bank is required to continue publishing accounts in accordance with company law and the Listing Rules, which may be unlikely in the case of a referral, it is for the directors and the auditor to understand the position and ensure that the respective disclosure requirements are met. At lower levels of escalation, there will be less certainty about the going concern status of the bank and greater judgment is likely to be needed about the extent of disclosures that may be required.

230. Where disclosure is considered necessary to comply with accounting standards, company law or the Listing Rules (which may occur at any level of escalation) and this obligation conflicts with a regulator's financial stability desire for secrecy, under the current legal framework it is for the directors and auditors to determine whether to make the necessary disclosures not the regulators. However, it is important for the matter to be discussed with the regulators because the fact of the proposed disclosure may in itself create further risk of stress to the going concern status of the bank, potentially raising the level of escalation and the need for additional actions to address those stresses.

231. The Panel has concluded that, notwithstanding the special nature of the risks and the importance of banks to the financial system and its stability, absent a legal basis for doing so, failure to provide the necessary disclosures appropriately reflecting the going concern status of the bank, or to give the required audit reporting, would constitute a breach of the directors' or auditors' duties.

232. In that context, the Panel has considered whether, as suggested by some commentators, there should be a separate disclosure regime for banks and their auditors in relation to the going concern assessment. What has been suggested is that the bank and the auditor would not make public disclosures about significant uncertainties (such as are implicit in the need for Government support or ELA) but would be required only to make disclosure to the regulators and, in the case of the auditor, also to the bank's Board. An alternative approach might be to introduce a specific derogation permitting delayed disclosure in accounts, subject to meeting a public interest test that could be subject to approval by the regulatory authorities.

233. The Panel recognises that such a regime would, in effect, further subrogate the rights of market participants – to be properly informed about the risks – to the rights of society to enjoy financial stability. As discussed in paragraph 176, there is a precedent for such derogation in relation to inside information but this is limited to the delayed disclosure of

the receipt of ELA by the bank. Furthermore, it should be recognised that any such change would require changes to EU law[46] as well as to UK law and regulations.

234. If it were considered appropriate for there to be such a regime, the Panel believes this is a matter of public policy that should rightly be considered and decided by Parliament (or by the relevant EU legislative organs) at the request of the Bank of England as the primary guardian of the public interest in financial stability. Accordingly, it is beyond the remit of the Panel and of the FRC and therefore the Panel makes no specific recommendation on this point.

235. The Panel also found the arguments advanced for considering the need for a separate financial reporting and auditing regime for banks (see paragraph 195) interesting. The Panel believes that its recommendations are responsive to the issues raised in relation to the going concern assessment, without the need for a fundamentally different approach for banks in this respect. However, there may also be merit in the FRC considering enhancing the guidance for directors and auditors by highlighting the special considerations for banks (perhaps through the introduction of an Appendix). If so, the Panel believes that it will be important to do this in a way that does not detract from the importance to non-financial entities of many of the lessons learned by banks in the crisis in relation to their assessment process.

236. Although the wider issue of a separate financial reporting and auditing system for banks was only raised spontaneously by a small number of commentators and is outside the Panel's remit, the Panel felt that it could merit further debate. In commenting on the recommendations and conclusions set out in this report, commentators may wish to provide a wider range of opinions on this matter.

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[46] Directive 2004/109/EC of the European Parliament issued in December 2004 dealt with transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market can be accessed at: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2004:390:0038:0057:EN:PDF and
Regulation (EC) No 1606/2002 of the European Parliament issued in July 2002 on the application of international accounting standards can be accessed at:
http://eurlex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2002:243:0001:0004:EN:PDF

Appendix 1 – Sharman Panel of Inquiry terms of reference

In the context of the recommendations in the FRC's recently published discussion paper 'Effective Company Stewardship – Enhancing Corporate Reporting and Audit' to examine the particular challenges faced by directors, management and auditors where companies face going concern and liquidity risks and to consider how such challenges should be addressed in the future. In particular, the Panel of Inquiry will examine:

- how companies ensure the adequacy, timeliness and reliability of the internal information used to monitor going concern and liquidity risks;
- how the Board and, separately, the Audit Committee approach going concern and liquidity risks, particularly in situations where these issues are of heightened importance,
- how the consideration of going concern and liquidity risk can best be incorporated into other aspects of stewardship and reporting;
- how auditors approach these matters, and
- whether the existing reporting regime and related guidance should be developed. In this regard, particular consideration will be given to whether:

    - the FRC Guidance for Directors of UK Companies, 2009 addressed the needs of management and Boards of companies facing going concern and liquidity risks;
    - the guidance contained in International Standard on Auditing (UK and Ireland) 570 - Going Concern should be developed in the light of lessons learned in the course of the credit crisis; and
    - the going concern and liquidity risk disclosures required by IFRS, the Code and the Listing Rules provided timely and relevant information for all stakeholders.

Appendix 2 – Sharman Panel of Inquiry call for evidence

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

CALL FOR EVIDENCE

Going concern and liquidity risks: Lessons for companies and auditors

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

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

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

Transparency of going concern and liquidity risk

1. What combination of information about:

   - the robustness of a company's capital;
   - the adequacy of that capital to withstand potential losses arising from future risks; and
   - the company's ability to finance and develop its business model.

   would best enable investors and other stakeholders to evaluate the going concern and liquidity risks that a company is exposed to? How effectively do current disclosures provide this information?

2. What type of disclosures (if any) have been made into the market place outside annual and interim corporate reports about current stresses being experienced by the company and about the management of those stresses? How do these disclosures interact with the requirement to disclose principal risks and uncertainties in the Business Review and the required disclosure on going concern and liquidity risk in the annual and interim financial statements?

3. Are there any barriers within the current corporate reporting environment to companies providing full disclosure of the risks associated with going concern and liquidity both within and outside the company's annual and interim reporting? Are there any changes that might be made to encourage companies to give fuller and more transparent disclosures in this respect?

4. Given the current measurement, recognition and disclosure requirements of International Financial Reporting Standards (IFRS), how effective are IFRS financial statements in enabling stakeholders to evaluate the robustness of a company's capital in the context of the going concern assessment? Are there any changes that could be made to these requirements that would better enable them to do so?

Company assessment of going concern and liquidity risk

5. What processes are undertaken by directors in making their assessment of whether the company is a going concern when preparing annual and half-yearly financial statements?

   - Which records and information are referred to in making this assessment?
   - What type of model does the company use to develop scenarios to stress-test the assumptions that have been made when making this assessment?
   - What types of risks are included in the going concern assessment: financial, strategic, operational, other? How are these presented in the assessment?
   - What is the role of the audit committee and risk management committee (where one exists) in this process and what inputs do they receive in order to carry out this role?
   - What impact has undertaking the going concern assessment had on the planning and management of the company?
   - How has the assessment of going concern and liquidity risks been incorporated into other aspects of company stewardship and reporting?
   - How effective is this assessment in addressing the robustness and adequacy of a company's capital and its ability to continue financing and developing its business model? What, if any, improvements could be made?

6. What is different about the review of going concern when raising capital compared to the annual going concern assessment undertaken for accounting purposes? Could some of the different procedures be used in the annual accounting or audit assessments?

7. Does the company assess future cash flows and liquidity on a regular basis throughout the year? If so, how regularly is this done and is the information used any different to that used in the annual and half-yearly assessment for the purpose of preparing financial statements?

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

9. The current model of disclosure identifies three categories of company[47]. What sort of behaviours does this model drive? Is there a different model that might be useful? Would more guidance on the application of the current model be helpful?

10. In your experience, what issues have resulted in a heightened focus on the assessment of going concern? What was the nature of the risks that gave rise to these circumstances? Had these risks been identified in advance, and if so, how?

The auditor's approach to going concern and liquidity risk

11. How does the auditor approach the assessment of going concern and liquidity risk? To what extent does this involve the testing of the company's processes and what other work is carried out? Is there any specific reporting on the work done by the auditor on going concern and liquidity risk to Audit Committees? Does the assessment of going concern involve different processes in certain industry sectors? Are there different processes used where there is overseas reporting in addition to UK reporting?

Feedback on the Guidance for Directors of UK Companies in respect of going concern and liquidity risk

12. Do you believe that amendments to the Guidance for Directors of UK Companies in respect of going concern and liquidity risk would be helpful? For example:

    - Guidance for directors on disclosures does not specify the language to be used, whereas auditors use more standardised wording. Is this helpful?
    - Is there a need for a clear boundary between the three types of company?

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

Please note:

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

Evidence submitted should be printed or typed and set out in numbered paragraphs, clearly indicating the author's name, address and status and whether the evidence is submitted on an individual or corporate basis. Additionally authors should note from what perspective(s) they are writing their evidence, both in terms of their current and past roles and the industry their

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

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

experience relates to. If experience has been gained in more than one industry, any differences should be drawn out in the body of the evidence. Submissions by e-mail are preferred (as attachments in Word), with a signed, hard copy to follow.

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

Evidence and enquiries should be addressed to:

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
11 May 2011

Appendix 3 - Written evidence received by the Sharman Panel of Inquiry

Investors and investor representatives	
Association of British Insurers The British Private Equity and Venture Capital Association Hermes Equity Ownership Services Investment Management Association Local Authority Pension Fund Forum	National Association of Pension Funds Pensions and Investment Research Consultants Ltd UK Individual Shareholders Society UK Shareholders Association Confidential response
Corporate respondents	
The 100 Group of Finance Directors Anglo American BAT Barclays (Treasury) BHP Billiton BP BT CBI David Challen John Coombe GlaxoSmithKline	Peter Hooley HSBC Lloyds Banking Group Brendan Nelson Old Mutual The Quoted Companies Alliance Standard Chartered Standard Life Alan Stewart Unilever Confidential response
Individuals with recent experience of corporate liquidity issues	
Peter Grant Charles Hindson	Confidential response x2
Finance providers	
Barclays	Confidential response x2
Accountancy profession	
ACCA Baker Tilly BDO Chartered Accountants Ireland Deloitte Ernst & Young Grant Thornton UK	ICAEW ICAS KPMG Kreston UK Mazars PKF PricewaterhouseCoopers
Other	
The Association of Corporate Treasurers British Bankers' Association Sir Adrian Cadbury Professor David Citron Professor Stella Fearnley	London School of Business & Finance Peter Nyberg Office of the Director of Corporate Enforcement Confidential response

Appendix 4 – Going concern research findings

Introduction

1. The Panel Secretariat undertook a high level exercise to identify the principal elements of existing academic and other research relevant to the Panel's remit and the conclusions drawn from that research. This did not constitute a comprehensive or systematic review of the literature. The Panel would be interested to hear from respondents to the Consultation if there are other important strands of research which it should be made aware of. The principal areas of research covered were as follows:

   - The nature, causes and costs of corporate financial and economic distress and failure (paragraphs 28 to 55)
   - Company disclosures about the going concern status of entities (paragraphs 56 to 59)
   - The auditor's propensity to modify the audit report in relation to the going concern status of the entity when financial distress is indicated and the correlation between going concern modifications of audit reports and the subsequent bankruptcy of the entity (paragraphs 60 to 73)
   - User reactions to audit report going concern modifications (paragraphs 74 to 81)
   - The vulnerabilities of banks during the financial crisis (Chapter 7).

2. The Secretariat also undertook some new analysis to identify the extent to which financial distress was experienced by publicly traded UK companies during the recent financial crisis and the extent of company and auditor signalling of such distress compared to the nature and timing of market awareness of the issues. The results of this work are set out in paragraphs 4 to 26 below.

3. A number of respondents to the Call for Evidence (primarily corporate and professional respondents) suggested particular aspects of the going concern issue in relation to which they thought it would be helpful for the Panel to consider what research is available and/or to consider undertaking further research. The particular aspects suggested, and the extent to which these were considered or addressed by the Panel, are as follows:

   Covered by the survey of research referred to in paragraph 1

   - The causes of financial distress and corporate failure
   - User reactions to audit report going concern modifications

   Considered in light of the new analysis referred to in paragraph 2

   - Whether, in recent cases of failure, the pre-failure financial statements provided effective forewarning of the subsequent difficulties

Considered in light of evidence received but relevant research not identified or undertaken

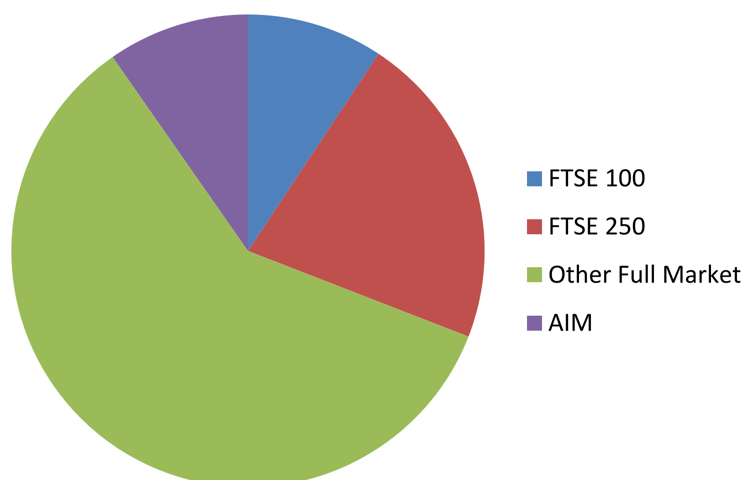
- Whether going concern information in the annual report is appropriate from a (lending) bank's perspective (see Chapter 3)
- Whether reporting of significant going concern uncertainties (and a modified audit report) is a self-fulfilling prophecy (see Chapter 5)

No further research was identified or undertaken

- Directors' propensity to report frankly on going concern problems (even when the audit report is modified) and to disclose an expected modification in their preliminary announcements – the suggestion was to update certain previous research[48]

Analysis of financial distress experienced during the recent crisis

4. Using a proprietary database, the Panel identified 1,042 UK companies that were either (a) listed on the London Stock Exchange or (b) admitted to trading on the Alternative Investment Market of the London Stock Exchange (AiM) at the end of February 2008 and had a market capitalisation in excess of £50 million on 1 March 2008. These companies fell within the following market segments:



5. In order to identify not only those companies that went into administration or liquidation but also other companies that appeared to have experienced significant economic or financial difficulties, each of the 1,042 identified companies was assessed as to whether it exhibited characteristics that matched any of the five potential indicators of distress listed in the Table below (items A to E).

[48] The reference was to two papers discussed at paragraphs 56 and 57 of this Appendix.

Table 1 – Selected characteristics as potential indicators of distress

A	The company went into administration or liquidation before the end of 2009
B	The company was taken over or merged with another company before the end of 2009
C	The auditor's report contained a going concern emphasis of matter paragraph in 2007, 2008 or 2009
D	The company undertook an emergency rights issue in the UK during 2008 or 2009[49]
E	The company's share price underperformed[50] the FTSE All-Share Index by more than 75% over any of the twelve month periods to February 2008, June 2008, November 2008, February 2009 or July 2009.

6. Characteristics A, B and D are indicators of a relatively intense form of distress that led to failure or a significant reorganisation or recapitalisation. As such, these characteristics indicate the potential end-game for the distress – the potential for recovery or failure (resolution). Characteristic C is an endogenous indicator of distress, whereas Characteristic E is an exogenous indicator of distress, reflecting market knowledge from whatever source.

7. Characteristics B and E often do, but do not always, signify that a company has experienced economic or financial distress. In relation to certain companies that exhibited these characteristics, it was considered likely that they had not experienced distress and they were not treated as distressed for purposes of further analysis, as follows:

   - Trust companies which had gone into administration or liquidation by the end of 2009, or had been taken over. Eleven of the twenty five companies which had gone into administration or liquidation, and eight of the companies that had been taken over or merged with another company, by the end of 2009 were trust companies. The reasons for such events are often connected with a reorganisation, rather than going concern issues, for such companies and they were taken not to be distressed for the purposes of this analysis.
   - The reasons for a takeover or merger are many and varied. Of those companies which were taken over or merged with another company and were not trust companies, the share prices of twenty five had consistently outperformed the market prior to their

[49] This information was not available from the same proprietary database and was obtained from another provider.
[50] Share price performance is measured relative to the FTSE All Share Index. Performance is calculated as follows::
Share price performance for a period = 100*(Price Change - Index Change)/Index Change
Price Change = Share price at end of period/Share price at beginning of period
Index change = Index value at end of period/Index value at end of period
A negative performance value is referred to as "underperformance" and a positive value is referred to as "outperformance"

takeover or merger. This was taken to indicate that their takeover or merger was unlikely to have resulted from going concern issues.

8. It is recognised that the remaining companies that exhibited these characteristics could still include some which had not in fact experienced significant distress. Although a full analysis was not undertaken to make a judgment as to which had and which had not experienced such distress, the further follow-up in relation to a sample (see below) gives some sense of the relative likelihood. However, for the purposes of this analysis they have been treated as having experienced some level of distress.

9. The numbers of instances of companies exhibiting each of these characteristics was as follows (some companies exhibited more than one characteristic and are included more than once in the tables below – the data relates to 181 companies):

Table 2 – Frequency of incidence of potential indicators of distress

A	Administration/takeover	14
B	Merger/takeover	39
C	Emphasis of matter	48
D	Emergency rights	56
E	Share price underperformance	101
	Total number of instances	258

10. A cross-sectional analysis, by market segment, of the incidence of these characteristics amongst these 181 apparently distressed companies is set out in Table 3 (frequency), Table 4 (frequency as percentage of the total number of companies in that segment) and Table 5 (frequency as percentage of the total number of distressed companies in that segment).

Table 3 – Frequency of distress characteristics by market segment (numbers)

	FTSE 100	**FTSE 250**	**Other main market**	**AiM**	**Total**
A	-	-	13	1	14
B	3	8	22	6	39
C	1	9	30	8	48
D	14	33	8	1	56
E	5	23	53	20	101
Total instances	23	73	126	36	258
Instances per company	1.2	1.6	1.5	1.2	1.4
Total apparently distressed companies	*19*	*47*	*86*	*29*	*181*
Total companies in segment	*97*	*225*	*619*	*101*	*1,042*

Table 4 – Frequency of distress characteristics by market segment (percentage of total companies in segment)

	FTSE 100	FTSE 250	Other main market	AiM	Total
A	0%	0%	2%	1%	1%
B	3%	4%	4%	6%	4%
C	1%	4%	5%	8%	5%
D	14%	15%	1%	1%	5%
E	5%	10%	9%	20%	10%
Total No. of instances	24%	32%	20%	36%	25%
No. of apparently distressed companies	20%	21%	14%	29%	17%
Total number of companies	100%	100%	100%	100%	100%

Table 5 – Frequency of distress characteristics by market segment (percentage of total apparently distressed companies in segment)

	FTSE 100	FTSE 250	Other main market	AiM	Total
A	0%	0%	15%	3%	8%
B	16%	17%	26%	21%	22%
C	5%	19%	35%	28%	27%
D	74%	70%	9%	3%	31%
E	26%	49%	62%	69%	56%
No. of apparently distressed companies	100%	100%	100%	100%	100%

11. By this aggregate measure of distress, there was a higher level of distress amongst the AiM companies than in any other segment.

12. Only fourteen companies (1.3%) went into administration or liquidation. None of these companies was in the FTSE 350 market segment.

13. The data suggests that the FTSE 350 companies were more likely to respond to distress with a rights issue to build up their capital base, were less likely to submit to a takeover or merger, were less likely to have a going concern emphasis of matter paragraph in their audit opinion and their share prices were less likely to underperform the market, as compared with the other smaller cap segments.

14. The following two Tables indicate the degree of correlation between the different characteristics exhibited. Each row shows, for a particular characteristic, the number (Table 6) or percentage (Table 7) of instances when it was correlated with each of the other characteristics.

Table 6 – Correlation of distress characteristics (number of instances)

Group	No. also displaying indicator A	No. also displaying indicator B	No. also displaying indicator C	No. also displaying indicator D	No. also displaying indicator E
A	14	-	2	1	12
B	-	39	6	2	6
C	2	6	48	3	27
D	1	2	3	56	17
E	12	6	27	17	101

Table 7 – Correlation of distress characteristics (percentage of instances)

Group	% also displaying indicator A	% also displaying indicator B	% also displaying indicator C	% also displaying indicator D	% also displaying indicator E
A	100%	-	14%	7%	86%
B	-	100%	15%	5%	15%
C	4%	13%	100%	6%	56%
D	2%	4%	5%	100%	30%
E	12%	6%	27%	17%	100%

15. Of those instances where a company went into administration or liquidation, the share price of a large proportion (86%) also underperformed the market by 75% or more. Nonetheless, very few of these companies (7%) have an emphasis of matter paragraph in their audit report.

16. Of those companies that went into administration or liquidation following a period where their shares significantly underperformed the market, but which did not have an emphasis of matter paragraph in their audit report, the average period of underperformance was seven months and the actual period of underperformance was six months or less in 70% of such cases.

17. A relatively small number of the instances of takeover or merger were accompanied by a going concern emphasis of matter paragraph (15%) or significant share price underperformance (15%). As indicated above, it is possible that some of these companies did not actually experience significant distress and were taken over or merged for other reasons. Further analysis of a sample of thirteen such companies indicated that it was not financial or economic distress that led to the takeover or merger in approximately 30% of cases. Even adjusting for this level of non-distressed companies suggests that a going

concern emphasis of matter paragraph only signalled a distressed takeover in a little more than 20% of cases.

18. Of those instances where there was an emphasis of matter paragraph in the auditor's report, only 4% were followed by administration or liquidation, and a further 13% were taken over or merged.

19. In 56% of those instances where there was an emphasis of matter paragraph, there was also significant share price underperformance, suggesting that such underperformance can be a strong indicator of going concern issues.

20. In relation to the instances of significant market underperformance, an emphasis of matter paragraph was also included in the auditor's report in 27% of cases.

21. Some companies had more than two distress indicators in the data:

- 2 companies went into administration after underperforming the market by 75% or more and having a going concern emphasis of matter paragraph in their audit report.
- 1 company went into administration after underperforming the market by 75% or more and undertaking an emergency rights issue.
- 2 companies were taken over or merged after underperforming the market by 75% or more and having a going concern emphasis of matter paragraph in their audit report.
- 1 company was taken over or merged after underperforming the market by 75% or more as well as having a going concern emphasis of matter paragraph in their audit report and undertaking an emergency rights issue.
- 2 companies underperformed the market by 75% or more as well as having a going concern emphasis of matter paragraph in their audit report and undertaking an emergency rights issue.

22. A sample of 34 of the above 181 companies was selected for further follow up. The selection basis was non-systematic. The characteristics of this sample of companies is indicated below:

Companies going into administration or liquidation before the end of 2009:		
Companies with no other signal that there was a going concern issue	2	
Companies with a going concern emphasis of matter paragraph who also underperformed the FTSE All-Share Index by >75%.	1	
Companies who underperformed the FTSE All-Share Index by >75%.	1	
		4
Companies being taken over or merged with another company before the end of 2009:		
Companies with no other signal that there was a going concern issue	8	
Companies with a going concern emphasis of matter paragraph	1	
Companies who underperformed the FTSE All-Share Index by >75%	2	
Companies with a going concern emphasis of matter paragraph and who underperformed the FTSE All-Share Index by >75%	2	
		13

Companies which survived the financial crisis:		
Companies undertaking an emergency rights issue	1	
Companies undertaking an emergency rights issue who also underperformed the FTSE All-Share Index by >75%	1	
Companies who undertook an emergency rights issue, had a going concern emphasis of matter paragraph and underperformed the FTSE All-Share Index by >75%	2	
Companies who underperformed the FTSE All-Share Index by >75%	5	
Companies with a going concern emphasis of matter paragraph who underperformed the FTSE All-Share Index by >75%	8	
		17
Total		**34**

23. Four of the eight companies that were taken over or merged with another company where there was no other distress indicator were actually found not to have any been taken over in connection with distress. The sample of companies looked at in more detail was therefore reduced to just 30.

24. By looking at this sample of companies in more detail, the Panel wanted to look at the factors that might have influenced the experience of distress, potentially leading to administration, voluntary liquidation or takeover with a substantial loss of value to the shareholders. Disclosures in the accounts and relevant press comments were considered for each of these 30 companies in order to develop a broad understanding of what had happened in each case.

25. For the 13 companies that survived the crisis (ie that did not go into administration, were not taken over and did not make an emergency rights issue), any emphasis of matter paragraphs in the auditor's report which was included in the audit report came after the significant underperformance of the share price in 88% of cases, suggesting further that the share price underperformance may be an earlier indicator of going concern issues than an emphasis of matter paragraph.

26. From an analysis of the results of these reviews, the following broad conclusions emerge:

- The most consistent factor being reported at some point amongst these companies (33%) was a potential covenant breach. This was especially true in the case of FTSE 350 companies, where the potential for a covenant breach was reported in 55% of the companies reviewed.
- Another widely reported factor was a profit warning (30%), although this was not so often the case for FTSE 350 companies (only 9% of the companies reviewed).
- The proportion of these companies, where a going concern emphasis of matter paragraph was issued and a potential covenant breach was also reported, was higher (43%) than in the sample overall (33%), suggesting that a potential covenant breach is seen by the auditor as a strong indicator of significant doubts about the going concern status. However, where an emphasis of matter going concern paragraph was included

in the auditor's report, only 21% of these companies had made profit warnings, compared with 30% in the sample overall, suggesting that a profit warning is less likely to be seen as an indicator of significant doubts by the auditor.

Survey of existing research

27. The principal sources of input to the high level survey of existing academic and other research were: comments on research in the responses to the Call for Evidence; the results of searches for academic material made available publicly on the internet; and information obtained as a result of enquiries made of a limited number of academics in relation to particular matters. The Panel is grateful for their input.

The nature, causes and costs of financial distress and corporate failure

28. There have been a number of research efforts directed at analysing the nature, causes and costs of financial distress and corporate failure. The Panel Secretariat would like to acknowledge one publicly available doctoral dissertation[51] that has been especially helpful in reviewing the development of academic research in these areas.

The nature of financial distress and corporate failure

29. Financial distress and corporate failure are not easy to define unambiguously and have been seen in different ways by researchers.

30. Sometimes they have been seen as the negative state of a binary condition – in this case, what constitutes distress or failure is an event switching the entity's condition from a positive state (economic or financial health) to the corresponding negative state. The condition and trigger events considered for this purpose do, however, vary from being the point of failure to the substantive point of entering distress.

31. The point of failure is easier to define but even so may take different forms (such as entering legal bankruptcy proceedings, incurring a contractual loan default, implementing a distressed restructuring, entering into a merger transaction) – see Beaver (1966)[52]; Andrade and Kaplan (1998)[53]; Baldwin and Mason (1983)[54]; Brown, James and Mooradian (1992)[55].

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[51] Natalia Outecheva (2007), *Corporate Financial Distress: An Empirical Analysis of Distress Risk*, Dissertation to obtain the title Doctor Oeconomiae from the University of St.Gallen, Graduate School of Business administration, Economics, Law and Social Sciences (HSG), available at: http://www1.unisg.ch/www/edis.nsf/wwwDisplayIdentifier/3430/$FILE/dis3430.pdf

[52] Beaver, W. (1966): *Financial Ratios as Predictors of Failure*. In: Journal of Accounting Research, 5, 71-111

[53] Andrade, G., Kaplan, S. (1998): *How Costly is Financial (Not Economic) Distress? Evidence from Highly Leveraged Transactions that Became Distressed*. In: The Journal of Finance, 53(5), 1443-1493

[54] Baldwin, C., and S. Mason (1983), *The Resolution of Claims in Financial Distress: The Case of Massey Ferguson* Journal of Finance 38, pp. 505-523

[55] Brown, D., James, C., Mooradian, R. (1993*): The Information Content of Distressed Restructurings Involving Public and Private Debt Claims*. In: Journal of Financial Economics, 33, 93-118

32. The substantive point of entering distress is harder to define and various approaches have been suggested (such as an event affecting the relationship with stakeholders that impairs access to new capital; the onset of chronic losses increasing liabilities and reducing the value of assets; a point when the probability of bankruptcy becomes critical – which depends on the level of liquid assets and credit availability) – see Opler and Titman (1994)[56]; Gestel et al (2006)[57]; Hendel (1996)[58].

33. The Panel notes that these two versions of the binary states approach articulate well with the two boundaries between the three categories of company in the current model of going concern disclosures[59].

34. An alternative to the binary states approach to distress and failure is to see them as elements of a dynamic and non-linear process, which starts with the entity beginning to exhibit signs of failing economic or financial health (the onset of distress) and continues until the distress has been resolved, whether through some form of failure or a return to economic and financial health – see Gordon (1971)[60]; Purnanandam (2005)[61]; Gilbert (1990)[62]; Ward and Foster (1997)[63]; Pindado and Rodrigues (2004)[64]; Turetsky and McEwen (2001)[65].

35. This is a more holistic approach that recognises that distress and failure have different characteristics. An entity can be distressed without ever reaching the point of failure. Failure is simply one of the possible outcomes of distress – during distress, the entity has the opportunity to recognise and respond to its problems and hence to recover. Failure

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[56] Opler, T., Titman, S. (1994): *Financial Distress and Corporate Performance*. In: The Journal of Finance, 49(3), 1015-1040

[57] Gestel, T., Baesens, B., Suykens, J., Van den Poel, D., Baestaens, D., Willekens, M. (2006): *Bayesian Kernel Based Classification for Financial Distress Detection*. In: European Journal of Operational Research, 172(3), 979-1003

[58] Hendel, I. (1996): *Competition under Financial Distress*. In: The Journal of Industrial Economics, 54(3), 309-324

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

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

[60] Gordon, M. J. (1971): *Towards a Theory of Financial Distress*. In: The Journal of Finance, 26(2), 347-356

[61] Purnanandam, A. (2005): *Financial Distress and Corporate Risk Management: Theory & Evidence*. Working Paper, Ross School of Business, University of Michigan

[62] Gilbert, L., Menon, K., Schwartz, K. (1990): *Predicting Bankruptcy for Firms in Financial Distress*. In: Journal of Business Finance & Accounting, 17, 161-171

[63] Ward, T., Foster, B. (1997): *A Note on Selecting a Response Measure for Financial Distress*. In: Journal of Business Finance and Accounting, 24(6), 869-87

[64] Pindado, J., Rodrigues, L. (2004): *Parsimonious Models of Financial Insolvency in Small Companies*. In: Small Business Economics, 22, 51-66

[65] Turetsky, H., McEven, R. (2001): *An Empirical investigation of Firm Longevity: A Model of the Ex Ante Predictors of Financial Distress*. In: Review of Quantitative Finance and Accounting, 16, 323-343

can also occur without (apparent) preceding financial distress but this may be driven more by management fraud than by 'natural' stresses – see Hopwood et al (1994)[66].

36. A third approach, that may be complementary to the other two approaches, is to define distress or failure by reference to technical measures of its symptoms that indicate or predict it. This approach is often taken in research for the selection of samples for study. Two broad methodologies can be identified – the use of one or more financial ratios derived from the entity's published data and the use of combined financial and market based indicators. The technical measures are generally derived from empirical studies.

37. Examples of such indicators include:

- financial indicators used alone or in combination with each other – persistent losses, dividend reductions, persistent significant shortfalls in EBITDA over interest expense, financial restructuring, massive layoffs – see Denis and Denis (1995)[67], Asquith et al (1994)[68], Platt and Platt (2002)[69]; and
- combined financial and market indicators – negative sales growth together with negative share price returns, operating cash flows are insufficient to meet obligations together with a decline in market value – see: Opler and Titman (1994)[56] and Whitaker (1999)[70]. Perhaps the most comprehensive approach was developed by Altman (1968)[71] – his Z-score used a combination of five factors (four financial and one market based).

38. Researchers do not generally have access to the internal information resources of companies or auditors. Most of the academic research surveyed is therefore necessarily based on externalised information about corporate condition and performance and about the audit. In relation to companies, such information includes not only the information disclosed by companies and their auditors but also other market knowledge that may have been derived from many diverse sources.

39. These sources include information gleaned from contacts with employees, customers, suppliers and other stakeholders who have direct knowledge about the entity's business. Such information is not usually documented formally. Nonetheless it is shared among market participants in relation to publicly traded entities.

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[66] Hopwood, W., McKeown, J., Mutchler, J. (1994): *A reexamination of Auditor versus Model Accuracy Within the Context of the Going-Concern Opinion Decision*. In: Contemporary Accounting Research, 10, 409-431

[67] Denis, D., Denis, D. (1995): *Causes of Financial Distress Following Leveraged Recapitalizations*. In: Journal of Financial Economics, 37, 129-157

[68] Asquith, p., Gertner, R., Sharfstein, D. (1994): *Anatomy of Financial Distress: An Explanation of Junk Bond Issuers*. In: The Quarterly Journal of Economics, 109, 625-658

[69] Platt, H., Platt, M. (2002): *Predicting Corporate Financial Distress: Reflections on Choice-Based Sample Bias*. In: Journal of Economics and Finance, 26(2), 184-199

[70] Whitaker, R. (1999): *The Early Stages of Financial Distress*. In: Journal of Economics and Finance. 23(2), 123-133

[71] Altman, E. (1968): *Financial Ratios, Discriminant Analysis and the Prediction of Corporate Bankruptcy*. In: The Journal of Finance, 22(4), 589-609

40. Taken together with information provided by companies and their auditors and with the views and assessments of equity and debt investors and investment analysts and rating agencies, this information influences the prices of such entities' securities. The equity share price performance and the cost of debt for publicly traded entities therefore reflect both internally and externally generated information about the entity, including the perceptions of capital market participants about its short and its longer term prospects.

41. The lack of a consistent definition for identifying companies subject to distress or failure as the basis for research means that some studies exclude certain types of companies suffering distress or failure (for example, a focus on those entering bankruptcy would exclude those that ultimately recovered, restructured their debt or were acquired) and care is needed in interpreting and comparing them.

The causes of distress and failure

42. There are many potential causes of distress and failure. The relationships between cause and effect can be complicated. Research typically classifies causes between whether they result from internal risks or external shocks.

43. There were a number of empirical studies of corporate failures in the 1970's and early 1980's[72]. Their purpose was to identify the causes and symptoms of failure in the expectation that this would either better enable companies to anticipate and avoid failure or better equip turnaround specialists to do their work once failure had occurred.

44. They generally concluded that internally generated (endogenous) rather than externally generated (exogenous) factors were the major causes of corporate distress and that the significant majority could be attributed to management weakness.

45. The results of later studies in the 1990's and 2000's have been more mixed, with some showing stronger causal links to external factors such as recession, increasing foreign competition and (for highly leveraged entities) short term interest rates, industrial downturn and industry-wide problems[73]. One such study suggested that unanticipated

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[72] E. Altman (1971) *Corporate Bankruptcy in America*, Heath, Lexington, Mass.
J. Argenti (1976) *Corporate Collapse: The Causes and Symptoms*, McGraw Hill, London.
D.B. Bibeault (1982) *Corporate Turnaround*, McGraw Hill, N.Y.
D. Schendel, G.R. Patton & J.Riggs (1976) *Corporate Turnaround Strategies: A Study of Profit Decline and Recovery*, in Journal of General Management Vol. 3 No. 3, Spring.
S. Slatter (1984) *Corporate Recovery*, Penguin Books, Harrnondsworth, Middlesex, England.

[73] John, K. Lang, L., Netter, J. (1992): *The Voluntary Restructuring of Large Firms in Response to Performance Decline*. In: The Journal of Finance, 47(3), 891-917
Kaplan, S., Stein, J. (1993): *The Evolution of Buyout Pricing and Financial Structure in the 1980s*. In: The Quarterly Journal of Economics, May, 313-357
Denis, D., Denis, D. (1995): *Causes of Financial Distress Following Leveraged Recapitalizations*. In: Journal of Financial Economics, 37, 129-157
Opler, T., Titman, S. (1994): *Financial Distress and Corporate Performance*. In: The Journal of Finance, 49(3), 1015-1040
Nwogugu, M. (2004): *Corporate Governance and Risk: The Externalities/Governmental Influence Theories of the Corporate Entity and Financial Distress*. Working Paper

shocks had caused the distress in between 15% and 40% of the companies studied – see Nwogugu (2004)[73]. Other studies continued to show stronger links to internal factors[74].

46. Another study of companies entering Chapter 11 in the US suggests that the factors causing distress in periods of economic growth and downturn are different. In the first case, factors causing distress were found to be low productivity and internal inefficiencies. In the second case, it was found to be externally generated, driven by customers, competitors and the management.

47. The most significant causes of distress identified in such studies are as follows:

- Internal factors – bad management; poor operational performance; and high leverage
- External factors – economic shocks, overcapacity and structural changes, deregulation of key industries and natural disasters.

48. The causes of distress and failure do not necessarily operate independently of each other. In any particular case, they may be several and interrelated. Although poor management may be the most common cause of financial distress, it could be on-going for some time without becoming evident, leaving the entity vulnerable to the effects of an external shock.

49. Economic distress can be distinguished from financial distress. Sustained weak or negative profitability (below the cost of capital) is symptomatic of a weak or failing economic (business) model. If not addressed, this will (at least in time) lead to financial distress and ultimately to failure but the entity may survive for some time with such factors at play without evident financial distress.

50. An entity is generally considered to be in financial distress when there are serious questions about its ability to meet its financial liabilities in full (an outright problem, independent of timing) or when they fall due (a short term timing issue). The second of these can arise through problems either with the entity's short term cash generation or with access to liquid resources (either the ability to liquidate its own assets or to obtain new liquid resources externally).

51. Financial distress can occur without economic distress but will eventually follow if economic distress remains unaddressed.

Costs of distress

52. Research in this area tends to address the nature and magnitude of the costs of distress in order to consider the impact on corporate valuation. It distinguishes between the direct costs of distress resolution (such as the costs of debt restructuring, insolvency or

[74] Asquith, P., Gertner, R., Sharfstein, D. (1994): *Anatomy of Financial Distress: An Explanation of Junk Bond Issuers*. In: The Quarterly Journal of Economics, 109, 625-658
Andrade, G., Kaplan, S. (1998): *How Costly is Financial (Not Economic) Distress? Evidence from Highly Leveraged Transactions that Became Distressed*. In: The Journal of Finance, 53(5), 1443-1493
Whitaker, R. (1999): *The Early Stages of Financial Distress*. In: Journal of Economics and Finance. 23(2), 123-133

administration procedures, etc) and the indirect costs that result from the distressed conditions themselves (for example, the inefficiencies that result from any endogenous causes of the distress as well as the impact of the distress on the entity's market share, restrictions in its supply chain, loss of key staff and its ability to invest etc).

53. Direct costs are relatively easy to measure whereas indirect costs are less easy to identify and measure. Research has focused more on the direct costs of distress. Indirect costs are usually estimated indirectly because they are not readily observable by researchers.

54. Research findings suggest that the indirect costs of distress are more significant than the direct costs and that they occur throughout the period of distress and increase in intensity during that process.

55. Estimates of direct costs of resolution vary up to 5% of the pre-distress value of the entity – they arise during resolution. Estimates of indirect costs vary anywhere from 10 to 80% of pre-distress value, depending on the circumstances, and occur largely prior to resolution of the distress. These costs are high when the entity is also exposed to macroeconomic shocks and negligible in their absence[53]. Better liquidity results in lower opportunity losses[64].

Research into the quality of company disclosures

56. Two research papers reported in 2006 and 2008 considered the quality of directors' going concern disclosures. Later studies have not been identified. The first of these[75] looked at 179 UK firms that received audit going concern modifications between 1994 and 2000. The key finding was that directors were reluctant to report frankly about going concern problems even if the facts were recorded elsewhere in the annual report. 18% of cases made no direct comment about their going concern problems and 31% made 'optimistic' disclosures. A second finding was that certain auditor characteristics (such as a presumed higher reputation) and certain corporate governance related characteristics (such as relatively high institutional ownership) were associated with more appropriate management disclosures.

57. The second paper[76] looked at the propensity of directors to announce a forthcoming going concern audit report modification in their preliminary announcements. The researchers found that 58% of companies who received going concern audit report modifications between 1994 and 2000 did not report the forthcoming modification in their preliminary announcements. The Listing Rules have subsequently been amended to require such disclosure

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[75] *Management Going Concern Disclosures: Impact of Corporate Governance and Auditor Reputation* by Uang et al. (European Financial Management, Vol.12 No.5, 2006, pp.789-816)

[76] *Delays in Reporting Price-Sensitive Information: The Case of Going Concern* by Citron et al. (Journal of Accounting and Public Policy, Vol.27, 2008, pp.19-37)

58. A survey of financial statements and narrative reporting by UK listed companies has been undertaken annually by Deloitte. The surveys of annual reports for 2009 and early 2010[77] included the following observations:

- 95 of 100 companies identified their principal risks and uncertainties in their narrative reporting. Financing issues (i.e. factors affecting the company's ability to raise finance or meet loan covenants in the future) were some of the common risks identified.
- The statement on going concern was most commonly included in the director's report (50% of companies) although a significant proportion of companies (34%) included it in the corporate governance statement and others (11% of companies) included it in a stand-alone business review.
- 63% of companies were thought to have clearly adopted the Guidance for Directors with 59% including material (or a cross-reference) on principal risks and uncertainties, liquidity and key judgments made in the going concern assessment.
- 38% of companies referred to an uncertainty in their going concern statement, relating to matters such as financing and shareholder support, trading volumes and breach or potential breach of covenants. None of the largest companies included this last matter in such a list.
- 87% of companies did not disclose the length of forecasts or budgets relied upon to support the going concern assumption.
- Rexam and Triad were identified as examples of good disclosure.
- 4% of companies had an emphasis of matter paragraph in their auditor's report.

59. The Deloitte survey of half-yearly financial reporting published in March 2011[78] identified the following:

- 95% of companies included a statement on going concern and/or an informative discussion on going concern and financial resources.
- Of two companies who had received a going concern emphasis of matter in their most recent auditor's report, one company made reference to agreement of revised bank facilities and the other provided no comment on going concern.

Auditing research relevant to the going concern status

60. Auditor reporting behaviour in relation to the going concern issue has also been the subject of considerable research effort[79].

61. Auditors are required to signal in their audit reports when they consider that 'a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a

[77] *Drowning by numbers: Surveying financial statements in annual reports* and *Swimming in words: Surveying narrative reporting in annual reports*
[78] *Six of one: Surveying half-yearly financial reporting*
[79] The Panel Secretariat is grateful to Dr Elizabeth Carson, Associate Professor, School of Accounting, Australian School of Business and to her PhD student Per Christen Trønnes for access to a recent, as yet unpublished, literature review in this area

going concern'[80]. This signalling usually occurs through the inclusion in the audit report of a going concern emphasis of matter paragraph.

62. The decision whether or not to include such a paragraph in the audit report is a highly judgmental one. The auditor is required to undertake an active, but proportionate, investigation of the entity's going concern status (informed by their risk assessment). The inclusion of such a highly visible paragraph in the audit report and the highly judgmental nature of the decision has attracted considerable academic interest in this aspect of the audit as a means of studying one aspect of audit quality.

63. One major avenue of research has been to consider the auditor's propensity to issue such a paragraph and what factors affect it. This is of interest in considering the consistency with which auditors approach the going concern issue, not only in a particular business environment but also internationally in the context of the continuing development towards the acceptance of international auditing standards.

64. There is a considerable body of research that studies the association of going concern audit report modifications with the audited entity's distress characteristics. Early research generally suggested that the auditor's propensity to make report modifications is systematically related to publicly available information and can be statistically modelled. It was even suggested that auditors' opinions are inferior indicators of bankruptcy relative to statistical models. However, Hopwood et al (1994)[81] suggested that this conclusion is not sound, arguing that the predictive value of statistical models is generally overstated because they do not adequately reflect the conditions under which auditors are making their assessment. Auditors are faced with populations with low (in the region of 1%) frequencies of bankrupt companies rather than the 50% or more frequencies that are reflected in most samples for prediction models. Also, in the real world that auditors face, they approach evidently stressed entities in a different way than other entities whereas prediction model samples are not usually partitioned between these two types. When these factors were adjusted for, they found that statistical models were no longer superior to the auditor in predicting bankruptcy. However, they concluded that neither auditors' opinions nor statistical models are very good predictors of bankruptcy.

65. The studies generally adopt an established statistical model for predicting the future viability or otherwise of the audited entity, comparing the model prediction of failure with the incidence of a modified going concern audit report and then identifying two types of "error". A Type I error is when a going concern audit report modification is issued but the entity remains viable and a Type II error is when the entity does not receive such a modification and the entity is predicted to fail. A key difficulty with this approach is defining failure. As discussed above, financial distress is not best characterised as a binary

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[80] See ISA (UK and Ireland) 570 – *Going Concern*, paragraph 9(b) available at:: http://www.frc.org.uk/images/uploaded/documents/ISA%20(UK%20and%20Ireland)%20570%20(final).pdf

[81] Hopwood, W, McKeown, J and Mutchler, J (1994), *A Re-Examination of Auditor versus Model Accuracy within the Context of Going Concern Opinion Decision*, Contemporary Accounting Research, Vol. 10, No. 2, pp. 409-431

condition but rather as a dynamic non-linear process that may have a number of possible end-games, including recovery or resolution (including failure).

66. This type of study generally shows that up to 90% of audit modifications result in a Type I "error" and that Type II "errors" can occur as frequently as in 40-50% of cases of (predicted) failure. However, it should be recognised that a Type I "error" does not necessarily mean that the modification was inappropriate if the company subsequently took action to address the issues causing significant doubt and they were resolved. Similarly, whether or not a Type II error represents an audit failure to identify or to report significant doubts depends on the facts of the case. One problem academic researchers face is that they do not have access to insider information.

67. Some, but relatively little, research has been done to consider the evolution of distress in companies that receive going concern modifications. Such studies may provide useful information about the validity of labelling Type I errors as such. One study[82] found from longer term tracking that about two thirds of 377 US companies that received a going concern modification between 1983 and 1991 eventually went into a bankruptcy procedure or merged (ie were resolved), with the other third surviving and having their modification withdrawn (ie recovered from distress). Another more recent study[83] found a similar ratio of resolutions to recoveries. The composition of resolutions is however different between the two studies and between different countries.

68. The statistical models for predicting failure vary in the literature. Financial ratios can be a strong predictor of going concern audit report modifications in their own right. Some studies show that stock market variables can add incremental explanatory power but others do not. Adding a loan default status variable can also add considerable predictive power.

69. Another avenue of research has been to consider how litigation risk (controlling for the degree of distress) affects the auditor's propensity to issue a going concern audit report modification. Various more general studies of audit quality suggest that litigation risk is a driver of audit quality and reporting.

70. Two US studies published in 2001[84] and 2006[85] considered the relationship between the propensity to issue a going concern modification and litigation risk. These studies considered the impact of the US Private Securities Litigation Reform Act of 1995, which

[82] Nogler, G (1995), *The Resolution of Auditor Going Concern Opinions*, in Auditing: in A Journal of Practice and Theory, Vol. 15, No. 2, pp. 54-73

[83] Zhao, S (2009), *The Successful Resolution of Auditor Going Concern Opinions: Evidence from the U.S. and Australia*, Working Paper

[84] Geiger, M and Raghunandan, K (2001), *Bankruptcies, Audit Reports, and the Reform Act*, in Auditing: A Journal of Practice & Theory, Vol. 20, No. 1, pp. 187-195

[85] Geiger, M, Raghunandan, K and Rama, D (2006), *Auditor Decision-Making in Different Litigation Environments: The Private Securities Litigation Reform Act, Audit Reports and Audit Firm Size*, in Journal of Accounting and Public Policy, Vol. 25, No. 3, pp. 332-353

reduced expected litigation costs to auditors. They found that the likelihood of a going concern modification being issued reduced after the passing of the Act.

71. A later study[86] suggests a higher propensity to issue modifications following the Sarbanes-Oxley Act in the US in 2002. The Type I error rate has increased (solely due to non-Big 4 firms) and the Type II error rate has decreased.

72. A recent study[87] suggests that in an environment of heightened distress auditors may assess an increase in their risk not only due to heightened litigation risk but also due to expected greater regulatory intervention. Other studies suggest that the reputation and professionalism of the auditor may be just as important a driver of reporting behaviour, especially in lower litigation risk environments.

73. Another area of research has been to consider whether the size of audit firm has an effect on the auditor's propensity to issue modifications. There is some evidence to suggest that there are differences but these are not well understood.

User reactions to audit report modifications

74. Another thread of research into the impact of the audit in relation to going concern, looks at investor reactions to the inclusion of an emphasis of matter paragraph in the audit report. It generally considers the impact on share returns in the period after an entity first receives an audit report including a going concern emphasis of matter paragraph. If the audit report is providing new information to the market, a negative impact might be expected.

75. There have been mixed results reported. Two studies in 1994 (Fleak and Wilson)[88] and 1996 (Jones)[89] observe negative returns. In contrast, in 2007, researchers examined companies a year after disclosure of first-time going concern opinions in the US and Australia[90]. They found no evidence of significant negative abnormal returns associated with going concern opinions, contrary to an earlier UK study[91] which had found a persistent significant negative return.

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[86] Myers, L, Schmidt, J and Wilkins, M (2008), *Have Auditors Become too Conservative? Evidence from Going Concern Opinions*, Working Paper

[87] Xu, Y, Carson, E, Fargher, N and Jiang L (2011), *Auditor Responses to Changes in Business Risk: The Impact of the Global Financial Crises on Auditors' Behaviour in Australia*, Working Paper

[88] Fleak, S. K., and E. R. Wilson. 1994. *The incremental information content of the going-concern audit opinion*. Journal of Accounting, Auditing & Finance 9 Winter: 149–166

[89] Jones, F. L. 1996. *The information content of the auditor's going concern evaluation*. Journal of Accounting and Public Policy 15 Spring: 1–27

[90] *Does the stock market underreact to going concern opinions? Evidence from the U.S.and Australia* by M Ogneva, K Subramanyam – Journal of Accounting and Economics (2007) Volume: 43, Issue: 2-3, Pages: 439-452

[91] *In denial? Stock market underreaction to going-concern audit report disclosures* by Taffler, Lu and Kauser (2004) Journal of Accounting and Economics 38, pp263-285

76. Another research study reported in 2007[92] examined the value added by an audit report through an investigation of the information content for entities receiving a first-time going concern emphasis of matter paragraph in their audit report. The researchers found no evidence of a short-term market reaction to the public announcement of a first-time going concern emphasis of matter. They did find a significant adverse medium-term market reaction in the 12 months prior to a first-time going concern emphasis of matter paragraph. This result suggests that the audit report confirms rather than announces the deteriorating financial condition of a firm.

77. A more recent study reported in 2010[93] looked at a relatively large sample of 1,194 companies that received an emphasis of matter paragraph in relation to going concern in their audit report in the period between 1995 and 2006. The study found strong evidence of a market reaction (negative returns) to going concern emphasis of matter paragraphs. The study not only looked at this question but also tried to understand why the market reacted in this way and what types of investors were responsible for the reaction.

78. Four different explanations were found as to why the auditor chose to include a going concern emphasis of matter paragraph: poor financial performance (75%), financing problems (35.5%), operating problems (21.2%) and other (11%). If the auditor cited financing problems as leading to the going concern uncertainty, investors were likely to react more negatively than where the audit report did not cite such issues.

79. Looking in more detail at the companies which received a going concern emphasis of matter paragraph citing financing problems, the investor reaction was even more negative in cases where lending agreements included a covenant that requires an audit report without a going concern emphasis of matter paragraph.

80. The reaction from investors is also more negative where there is a higher proportion of institutional investors. Such companies are likely to be larger, are earlier in their reporting and are more likely to have a Big 4 auditor. This creates a more negative market response for companies with a Big 4 auditor compared to those with a non-Big 4 auditor. This suggests that institutional investors drive the reaction to the going concern emphasis of matter paragraph, since there is no detectable reaction at low levels of institutional ownership. The market reaction gets more negative as the level of institutional ownership increases, and there is a decline in institutional ownership after the audit report is issued.

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[92] *The horse has bolted: revisiting the market reaction to going concern modifications of audit reports* by Kathleen Herbohn, Vanitha Ragunathan, Robert Garsden in Accounting and Finance (2007) Volume: 47, Issue: 3, Pages: 473-493

[93] *Investor Reaction to Going Concern Audit Reports* by Krishnagopal Menon, David D Williams in The Accounting Review (2010) Volume: 85, Issue: 6, Pages: 2075

81. Of all the companies receiving a going concern emphasis of matter paragraph in their audit report, 14.6% filed for bankruptcy in the 12 months following the date of the financial statements and 39.1% delisted. The likelihood of either of these events happening was no greater for those companies where financing problems were cited in the emphasis of matter paragraph than for companies with a going concern emphasis of matter paragraph citing other factors.

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