

The Sharman Inquiry

Going concern and Liquidity risks: Lessons for companies and auditors

Preliminary report and recommendations of the panel of inquiry¹

1 United Kingdom Shareholders' Association. (UKSA)

UKSA is a member funded and run organisation representing the interests of private shareholders in UK listed companies. We submitted a response to the Panel's Call for Evidence and now respond to the Panel's preliminary report and recommendations and the questions posed in that preliminary report.

2 Overall comment.

We welcome the thorough and extensive consideration of the going concern and liquidity risks. The panel has clearly done extensive research into the relevant factors and identified what it sees as the key issues. We generally welcome the thrust of its recommendations.

We are also appreciative of the invitation to add comments on matters other than those directly addressed by the questions laid out on page 13.

3 Specific comments

3.1 Lessons of the recent past

We are pleased to note that Lord Sharman, in his introduction, states that the aim of the Inquiry was "to identify lessons". We had noted, in our original response, that the original Call for Evidence had suggested that the aim was to capture the "lessons of the recent past" without identifying what those were.

3.2 Robust processes

There are, in several places in the Report, references to "robust" processes. We wonder if it would be helpful to expand on this word as it implies a degree of challenge of executive management that is often difficult and sometimes resented. An example of what is considered robust could help. The problem is recognised in Para 80.

3.3 Business cycle or cycles

This term is used several times, e.g. Para 14. Whilst we understand that the nature of businesses varies, we wonder if some definition of what is meant by this term could be helpful. This could include comment on what was thought to be the likely length of a cycle and the trend foreseen.

¹ Extracts from the Preliminary Report are in blue.

3.4 Prudence

We note the reference to the “need for a more prudent mind-set in making the going concern assessment than the more neutral approach that is adopted for purposes of financial reporting”. This clearly implies that it is possible for financial reports to be drawn up without the same degree of prudence that the Panel believes necessary for the purposes of going concern. We feel that some of the problems regarding going concern could be addressed by ensuring that accounts are, in fact, drawn up with due prudence as is required by the Companies Act 2006.² Such an approach would ensure that the capital of a company would not be overstated and thus would make clear to the reader of the financial statements its true resources available to withstand the risks the business faces. This concern seems to be supported by the comments in Para 64 that “directors are often inherently optimistic”. We would therefore support the view expressed in the second bullet point to Para 105 suggesting that IFRS are in need of fundamental change so as to reintroduce the concept of prudence. A recent report from the LAPF “UK and Irish Banks Capital losses- post mortem” http://staticweb.pirc.co.uk/LAPFF_Post_Mortem_report.pdf makes much the same point very eloquently.

An extensive further discussion of the failures of accounting rules has just been published by the Adam Smith Institute under the title “The Law of Opposites: Illusory profits in the banking sector”. http://www.adamsmith.org/sites/default/files/research/files/ASI_Law_of_opposites.pdf. This deals solely with the banking sector but the points it makes on accounting principles such as the need for prudence and the definitions of realised losses and profits apply to all businesses.

Attention to and correction of these accounting failures seems to us to be one very important way in which” the particular challenges faced by directors..... where companies face going concern and liquidity risks” (See terms of reference at Page 68) could be addressed.

In summary get the accounting right and potential problems of going concern will be acknowledged and addressed sooner.

4.0 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?

Whilst “appropriate business behaviours” are not defined we would support this proposal if it involves the concept of a stewardship of the shareholders’ money for a foreseeable future.

5.1 Question 2: Recommendations

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.

² See Companies Act 2006: S 830 Distributable profits, S830 (2) Realised profits, S841, S396 and S.I. 2008/209 Definition of liabilities.

Recommendation 1: Research into failures

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

We fully support this proposal as many private investors are dismayed that there appears to have been little or no considered investigation of what went wrong in the credit crisis in this country. This contrasts with the position in Ireland where the Nyberg report was produced. The somewhat limited FSA report into RBS has only just been published over 3 years after the event and has avoided serious criticism of the board of that company. UK shareholders, largely private, have been reduced to seeking to band together with a view to suing directors and others involved in the crisis, a very expensive process for individuals, even collectively.

5.2 Recommendation 2: The going concern assessment.

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 (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.

We fully agree that this needs reconsideration but have doubts about some of the comments made and the rationale employed. These are below.

5.2.1 Expectation Gap

5.2.2 Guarantee

The Report argues (Para 58 et seq) that there is an expectation gap in that stakeholders take the absence of a going concern disclosure as a “guarantee” of survival. We think this unlikely. Most private shareholders are generally fully aware of the risk of loss when investing in shares and do not expect any guarantees.

5.2.3 Regular consideration of going concern

We recognise the problem of the way in which going concern disclosure is currently handled and support the idea of a regular statement of how this issue has been thought about in order that directors are not faced with an all or nothing situation. We are, however unclear as to what the reference to “behavioural dynamics” in Para 65 means.

5.2.4 Different perspectives

We are also unclear as to the logic or indeed the relevance of Para’s 68-72. The Report there seems to argue that the directors will take undue risks with their shareholders’ capital. The report does not restate the obvious fact that losses fall firstly on the shareholders. It refers to what it calls “excess losses”- presumably those which arise after the shareholders’ capital has already been lost. It correctly states that the creditors’ claims have priority but then goes on to claim that the present rules giving that priority, in some way which is not understood, create “asymmetry”, presumably it is inferred, in favour of the shareholders and to the detriment of the creditors. The Report does, in Para 72, go on to list further protections which creditors frequently have which makes its comments on a “moral hazard” even more perplexing. Even if this argument of the Report were sustainable it is not clear how it impinges on the brief of the Panel.

5.2.5 Investors

We, as a body representing the interests of private shareholders, fully support the “preferred approach” of looking at going concern as integral to the management of the business (Para 79). We would not see this as being “culturally different” to a consideration of going concern for accounting purposes. The directors have an on-going responsibility to ensure the success of the business as best they can, and the consideration required for accounting purposes is simply one part of this. If the directors regard that accounting responsibility as something different from their day to day concerns then in our view they are not properly discharging their responsibilities.

We note (Para 82) that one respondent referred to “dialogue with company boards and management”. Private shareholders, of course, rarely have this advantage and thus have to rely on other sources. This fact reinforces the need for financial statements to be properly and prudently prepared, being the main source of information available to private shareholders.

5.2.6 Recommendation 2 Part a

We agree that clarification of the purpose of the going concern assessment is required. However we see no reason to reduce the requirements on the directors to express a view that the entity IS a going concern. Such a statement can be hedged by words such as “to the best of their belief” but should not be avoided.

5.2.7 Recommendation 2 Parts b and c

These are logical consequences.

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5.3 Recommendation 3: guidance for directors

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 mind-set. 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.

Bullet point one refers to the "right" focus on solvency. It would be helpful to expand on what is meant by that in this context.

There is also a reference to the "dynamics of its own business cycles". It would help directors if the meaning of this phrase was clarified.

5.3.1

We agree that going concern involves consideration of solvency as well as liquidity.

5.3.1.1 (Para 105)

As mentioned in our introduction we believe that a central part of the problem is the lack of prudence in IFRS accounts. It is arguable that this lack is contrary to the requirements of the Companies Act 2006. We see no advantage in drawing up, and do not believe the legal ability exists to draw up, accounts on a less prudent basis for accounting purposes and then recast those figures for the purposes of calculating the capital of the business, including its distributable reserves. We believe that directors would find it much easier to address the problems of the going concern assessment if they had a single set of figures to work on which they knew they had produced on a prudent basis.

5.3.1.2 (Para 109)

We do not understand the comment on "the likely impact of ...capital structure on ... default risk".

5.3.1.3 Stress testing (Para 118)

The value of this is wholly dependent on the assumptions made. It is noticeable that many European banks apparently passed stress tests set by their regulators which are now admitted to have been far too weak.

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5.4 Recommendation 4; Continuous consideration of going concern

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.

5.4.1

We agree with the proposal that going concern reporting should be an integral part of the directors' reporting, placed as suggested, in the discussion of strategy and principal risks.

5.5 Recommendation 5- Auditors

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.

We agree that the responsibilities of auditors should change if the idea of continuous going concern assessment is adopted. We agree that a positive statement from the auditor is essential. We, as UKSA, believe the auditor's hand could be much strengthened, both in this context and generally, by greater involvement from genuinely independent private shareholders in the appointment of auditors.

6.0 Question 3: Scope

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.

6.1 Investigations- Recommendation 1

Powers and procedures for investigating serious collapses must cover the potential to investigate all entities.

6.2 Going concern disclosures- recommendation 2

All businesses need continuously to consider the risks in their operations. The going concern assessment arises from this and we believe all entities should take this on board. Thus we would recommend that part of Recommendation 2 should apply to all reporting entities.

6.3 Solvency-Recommendation 3

Again this must be a matter for all entities.

6.4 Continuous assessment- Recommendation 4

This would logically follow for all entities.

6.5 Auditors- recommendation 5

Where entities are audited this recommendation should apply to all.

7.0 Question 4: Banks

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)?

From the extensive analysis of both the inherent problems of bank balance sheets and the particular ones which added to the recent credit crisis, certain themes can be detected,

7.1 Prudence

It is clear from several comments particularly in Para's 189 -207(E.g. 194) that there is a widespread view that accounting regulations under IFRS have deterred banks from taking a properly prudent view of their assets.³ This failure may have contravened the Companies Act which requires all "likely" losses to be taken into account. Irrespective of accounting regulations the Act requires boards to ensure that their accounts show a true and fair view.⁴ⁱ

³ See also references to the Adam Smith Report on bank accounting at 3.4 above.

⁴ See Moore opinion of 21 April 2008 which reaffirmed the primacy of true and fair under both UK and European legislation. See also the FRC statement of July 2011.

7.2 Management

It is of great concern to members of UKSA that the management of banks proved inadequate and little seems to have happened to rectify this.

Concern was raised over the “effective governance of risk..”(Para 199)

“the management did not amend risk controls” at Lehman’s when their strategy was changed.

(Para 210).

“results were not shared with senior management”. (Para 210)

“No such reports were made to the board” (Para 211)

Neither banks nor borrowers understood the risks they were taking and governance fell short of best practice.” (Para 214)

We recognise that, and indeed welcome the fact that, optimism is natural amongst business people. No-one would enter business without it. However this has to be balanced with a clear, consistent and considered prudent assessment of the risks faced, enforced by a board who genuinely understand them.

The boards’ responsibilities are well laid out in the last sentence of Para 224.

7.3 Stress tests

These are wholly dependent on assumptions made. If adequately prudent assumptions are made then they certainly have value. The report states that one needs to be aware “where management is on the optimism scale”. (Para 208)

7.4 Capital

We agree that there should be a consistent definition of capital- capital and reserves. If that were so no “sensitivity analysis” (Para 201) would be required. There are plans to increase banks’ capital which will help to minimise their risks.

7.5 Taxpayer support

The Vickers report on banking has suggested a form of separation of the activities of banks into those deemed less risky and more important to the community and those considered more risky and speculative. This should help ensure that lenders to banks fully appreciate the risks taken and the fact that banks will no longer have implicit taxpayer support,

7.6 Conclusion on banks

Clear investigation procedures for failed entities, resolute prosecution of failed boards and management where appropriate, a return to prudence, increased capital and a clear understanding

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of the certainty that taxpayer support will NOT be available in a crisis should be sufficient for inherently risky banks to be managed in a way for which the proposed going concern regime will be appropriate. A separate regime should not therefore be needed.

8.0 Question 5: Other comments

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

These have been made principally in Para's 2 and 3.

UKSA 20 December 2011