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Dear Sirs

**The Sharman Inquiry – Preliminary Report and Recommendations**  
***Going concern and liquidity risks: Lessons for companies and auditors***

We appreciate the opportunity to respond to this review being undertaken by the Panel of Inquiry led by Lord Sharman. We welcome the initiative of the Financial Reporting Council (FRC) to set up the Panel to identify, in the light of the credit crisis, lessons for companies and auditors addressing going concern and liquidity risks.

We responded in June to the Panel's initial call for evidence and continue to be willing to contribute views and provide experts from within our firm to assist the Panel if requested.

Our specific responses to each of the questions in the Panel's preliminary report are set out in the accompanying Annex. In this letter we highlight our views on what we consider to be some of the more important issues raised in the report.

**Enhanced narrative reporting on risk, financing and going concern**

We strongly support the Panel's recommendations for enhanced narrative commentary by companies on their business model, risks and financing. We think the basic mechanics of the current going concern assessment by companies and auditors have worked well in the last few years; but we believe the Panel has opened a broader dialogue on the array of information on risks, liquidity and funding with which company management, boards and investors are provided.

This is consistent with our view, noted in our previous evidence and in our response to the FRC's recent consultation on *'Effective Company Stewardship'*, that the corporate reporting model should be looked at afresh. There is a need for a more coherent picture of a company's

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strategy, business model, appetite for risk, key areas of risk, funding, and performance to be presented in annual reports (where narrative, financial and non-financial information are brought together).

While we agree that companies should consider both solvency and liquidity aspects in their assessments, there should be flexibility in how the recommendations are applied. Companies do not have identical circumstances and business models and therefore any final guidance should indicate that the weight given to the two aspects and the detailed specification of the related stress tests may differ.

### **The auditor's role**

Auditors have an important role to play in helping to ensuring that investors are provided with appropriate disclosures in the financial statements in relation to going concern. As we note in our response to Recommendation 5, the Emphasis of Matter is a powerful tool in the armoury of the auditor and we know from experience that the potential for its use can be helpful in encouraging companies to enhance the prominence of key disclosures in the financial statements. It provides a stronger means by which auditors can help to ensure that high quality financial disclosures are provided by companies than the approach suggested in the Panel's report. Until the model for company reporting changes significantly, we believe the current 'three category' approach ('clean'; emphasis of matter; and disagreement) should remain.

A number of standard setting and regulatory bodies are currently looking at the content and usefulness of the auditor's report. In particular, the International Auditing and Assurance Standards Board (IAASB) is undertaking a wide-ranging project, covering all aspects of auditor reporting. Since the standards used to audit many of the world's listed companies are now set principally at international level, we consider that different ideas on how the auditor reports on going concern would be best discussed in an international forum. The FRC should certainly propose ideas and take a leading role in that international debate, but we would be concerned if the FRC took actions that resulted in UK standards diverging from international standards.

### **Banks and going concern**

There is a valid debate to be had about the extent of going concern disclosure that is appropriate for banks. This is an important policy question and the Sharman report has helpfully set out the different considerations. We consider that, once it has assessed stakeholders' views on its preliminary report, the Panel should make a clear recommendation to public authorities on this matter.

We do not believe that a fundamentally different going concern disclosure and reporting regime for banks is warranted, but there should be a wider recognition of the dilemma highlighted in the Panel's report which is caused by the banks' fundamentally different business model. Enhanced narrative disclosure of a bank's business model and analysis of where its funding is coming from (perhaps similar to the traditional source and application of



funds statement) would help. The enhanced analysis and disclosure of solvency and liquidity risks recommended by the Panel for all companies will also be beneficial in the case of banks. Cases of distress are less likely to occur if assessments of solvency and liquidity are performed on a regular basis and built into the bank's normal control processes together with enhanced internal reporting routines.

As auditors, we are acutely conscious of the need for markets to have trust in reported financial information. That requires transparency and full disclosure. However, we also appreciate that in cases of extreme distress, it can be argued that there is a wider public-interest argument for maintaining confidentiality in order to preserve financial stability (albeit only temporarily until a crisis situation is stabilised). Because of the importance of maintaining trust in financial statements and the auditor's opinion, it is essential that this 'transparency versus stability' dilemma is resolved. Ultimately, it is a question that only politicians and lawmakers can answer, but the Sharman Panel should make a clear recommendation to those authorities on what it believes the appropriate course should be.

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

Yours sincerely

PricewaterhouseCoopers LLP

## **Detailed responses to the Questions in the Preliminary Report**

### **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?**

We agree that the going concern framework should encourage the corporate behaviours stated in Chapter 1 of the Panel's report:

- 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.

At the same time, we believe that an objective of the framework should be that it results in a better understanding of the process leading to the going concern assessment and its limitations by investors and others. This would include an understanding that they remain responsible for making their own economic decisions, while being provided with enhanced information with which to do so.

### **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.**

We have responded below in relation to each of the five recommendations separately.

#### **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 note that similar proposals are included in the BIS consultation on Reforms of the FRC, to which we will shortly respond.
- We agree with the principle that it is important to collect information on, assess and learn the lessons of failures of significant companies.

- We presume that the FRC's interest in this is to determine whether lessons can be learned from the perspective of financial reporting and auditing, rather than on any wider basis. We believe this would be best achieved in cooperation with the other agencies that already have powers and responsibilities to enquire into company failures, rather than through FRC launching its own inquiries.
- More important is what the FRC would seek to do with the information gleaned – it is not explained in the document how it would use the lessons learned from inquiries into company collapses. If the intention is to try to change company behaviour, then the lead for this must come from the corporate community itself – it is not something the FRC will be able to change simply through issuing more regulation and guidance.
- In summary, we believe any proposals should be further elaborated and carefully assessed, including an impact analysis, taking into account how any review conducted by the FRC of a company's governance, accounting and audit in those circumstances would fit with the existing investigative processes of other agencies. Any proposals to improve the method of analysing corporate failures should be based on a full understanding of the current system and evidence of why changes are needed.

### **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 FRS18 – 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 9.8.6R(3), in light of these changes;**
- (c) The FRC should engage with the IASB to seek amendments to IAS1 to accord with the resulting position in the Code and FRS18.**
- As noted in our previous response to the call for evidence, we agree there is a gap between the expectations of users in relation to the going concern statement in company annual reports and reality. 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. That is not, and can never be, the case. It would be beneficial if a result of the Sharman Inquiry was a greater appreciation by investors and other users of accounts of what the going concern assessment means, and its limitations.
- We agree that the FRC should take a lead, both in the UK and internationally, in debates on this topic and should take measures that will help reduce this expectation gap and avoid binary statements on going concern that may be misconstrued as a guarantee of solvency.
- To do this, we do not consider it is necessary to seek complete harmony between the Code and accounting standards as suggested in (a) above. The narrative commentary around the business model and sustainability of financing should remain as a

different layer of reporting to the more specific judgement of whether the going concern basis is appropriate for the preparation of the financial statements, albeit the latter should follow logically from the former and the linkage between the two should be clear.

- We believe that the FRC will be best able to achieve its objective of seeking improved behaviours and better information for investors on risk (as set out in Chapter 1 and referred to under Question 1 above) through encouraging changes in the narrative disclosures in the 'front half' of annual reports. Enhanced commentary on solvency and liquidity risks and the directors' process to arrive at their assessment would be more appropriate in the front half rather than including an extensive note in the financial statements.
- The FRC's Financial Reporting Laboratory would be a suitable place where new approaches to such reporting could be experimented with and trialled in a safe environment.
- If the narrative commentary in annual reports is enhanced as described above, the disclosures around the assessment of the going concern basis of reporting in the 'back half' financial statements should follow as a logical consequence. In this case it would not be necessary to seek changes to accounting standards such as FRS 18 and IAS 1.
- Moreover, in relation to the financial statements and audit report, it should be recognised that for UK listed companies the international frameworks of IFRS (for accounting) and ISAs (for auditing) are used, and hence any debate about those standards would need to take place within those international contexts. Progress can be made in the UK on enhancing the narrative disclosures by directors without the need for changes to accounting and audit standards.
- The FRC should certainly present arguments and proposed solutions that can be debated internationally, with the aim of persuading others of the merits of changes to corporate reporting practice. However we would be concerned if the FRC proposed changes to accounting and auditing standards or practice in the UK that could lead to inconsistency with practices widely used elsewhere and a lack of comparability for investors and others between the financial reports of UK companies and those of their international peers.

### **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.**

- The revised Guidance should emphasise that, as far as possible, the assessments related to going concern should be embedded in the normal routines and controls of the business, rather than being viewed as 'add-ons' specifically undertaken to satisfy period-end reporting requirements.
- Consistent with our previous submission, and as described elsewhere in this response, we believe that there should be an emphasis on broader financial sustainability, and an improved linkage in companies' consideration of - and reporting on - risk, financing and going concern.
- We agree that companies should focus on both solvency and liquidity risks. However, and as noted in our previous response, we believe that for non-financial companies liquidity is the more important criterion (most such companies that fail do so because they run out of cash, not because they run out of capital).
- We therefore think that although the Guidance for Directors should be amended to recommend that both solvency and liquidity aspects be looked at, this should not be done in a mechanistic or overly rigid way. Company circumstances differ depending on their business sector and a variety of other factors, and there will not be a 'one size fits all' combination of information on solvency and liquidity and related stress tests that suits all. Companies should not all be expected to apply a similar menu of assessments. In some cases, a 'reverse assessment' might be appropriate – examining what circumstances it would take to make the entity no longer a going concern and whether these present a credible future scenario.
- We note the recommendation that special consideration be given *"to the impact of risks that could cause significant damage to the community and environment."* We question how companies should interpret and apply this in practice. We noted in our previous response that the assessment of going concern and related disclosure in company reports should not be regarded as a proxy for addressing risks that should properly be dealt with by other types of regulatory monitoring regimes. If the sustainability of certain business sectors is judged critically important (because of the impact on wider society, the economy or employment should they fail) then there are other tools available to government, regulators and the industries themselves to address those risks. If the FRC is concerned about these aspects, then we suggest it should liaise with the other appropriate authorities to ensure that they are addressed.

**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 had 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.**

- We agree with the direction of these proposals. As noted in our previous evidence, we would welcome greater linkage by the directors between their discussion of the business model, strategy and risks, and the consideration of going concern.
- We very much support enhanced reporting by audit committees (as noted in our response to the FRC on *‘Effective Company Stewardship’*) on the key financial reporting judgments considered by the committee. This is something we have strongly advocated in discussions with our own audit clients.
- We believe the proposal in (b) should be that “the audit committee report *confirms* the effectiveness of the process undertaken by the directors...” We do not consider that the audit committee needs to illustrate or repeat the disclosures given by management, but merely confirm that it is satisfied that a robust assessment has been made.
- Similarly, we do not believe that this recommendation should refer to guidance for auditors as the position of preparers and auditors is fundamentally different. We respond on the audit aspects in relation to Recommendation 5.

#### **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 the 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 believe that auditors have an important role to play in helping to ensure that investors are provided with appropriate disclosures in the financial statements in relation to going concern.
- As noted in our previous evidence, we believe that the basic mechanics of the going concern assessment by companies and the related ‘three category’ audit approach have worked well in recent years. In particular, the Emphasis of Matter (‘EoM’) approach under the current model (including the use of the words “*material uncertainty that may cast significant doubt*”) is a powerful tool in the armoury of the auditor. We have found that the possibility of the use of the EoM is frequently a



useful means of persuading management to focus their attention on the issue, potentially take additional action, and enhance the prominence of the disclosure of the company's circumstances in the financial statements.

- The Panel's proposal to instead include a sentence in the audit report that the auditor has nothing to add to the disclosures provided by the directors is not in our view such a powerful tool. It relates to the more general description of the assessment process in the directors' commentary, rather than to the financial statements.
- The bigger question is whether the going concern focus and the related disclosure given by companies and auditors are at present too narrow. Until the model changes significantly, as we suggest below, we believe the current 'three category' approach should remain.
- Also as noted in our previous evidence, we would support a fuller going concern statement in annual reports, linked to the sections on funding and risks, setting out the key responsibilities and sensitivities. (If liquidity risks are a key issue for a particular company, then it might be appropriate to report on a suitable metric or KPI). Such a statement should provide greater explanation of the assumptions on which the statement is based, together with an indication of risks to which they are subject. The auditors could confirm that the assumptions and risks disclosed, overall, are a reasonable and balanced summary of the assessment that they have examined in the course of their audit and that nothing of significance has been omitted. It would also be possible to envisage a greater focus on judgmental statements about future risks but any more 'future-oriented' new model might require a change in mindset and approach by company management and directors, audit committees, auditors and other stakeholders, together with appropriate safe harbour provisions for directors and auditors.
- Regarding the suggestion that FRC encourage the IAASB to accommodate different approaches under International Standards on Auditing, we repeat some of our comments in relation to Recommendation 2. The FRC should certainly take a leading role in this debate and present arguments and proposed solutions that can be discussed internationally, with the aim of persuading others of the merits of making any changes to standards that are used around the world, but should not assume that any such accommodation can be made in the short term by IAASB.

**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.**

- We would prefer to see a consistent model and thought process applied to going concern regardless of the type and size of entity – the considerations of solvency and liquidity should apply to all. The only difference should be that, for listed companies and financial institutions, a greater degree of commentary and disclosure should be provided to investors and other users. In addition, some aspects of the Panel's

proposals, for example in relation to audit committees, will obviously be applicable principally to listed companies.

- The recommendations for enhanced commentary and disclosure by directors that apply to listed companies could also be applied to other types of entity in specific sectors to the extent that the relevant regulator for that sector decides it is appropriate. The FRC should provide a model for disclosures of financial sustainability that other regulators could adopt, obviating the need for them to design their own regulatory regime in this area. This would be good regulatory practice.

**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 (paragraphs 232-234)?**
- The Sharman inquiry report has helpfully highlighted the dilemma of going concern in relation to banks.
- The Panel will make a valuable contribution if it sparks an open debate among stakeholders regarding the twin objectives of ensuring financial stability and ensuring transparent financial reporting to investors. Both of these objectives are in the public interest but, in the context of a financial crisis, they may be inconsistent. Transparent reporting would dictate that companies and auditors should warn investors in banks if there is a significant uncertainty regarding the going concern status of the institution. But it seems hard to see how that reporting would not then lead to a run on the bank by depositors, which would rapidly lead to the institution's collapse and, potentially, more systemic consequences.
- In most cases, the potential for such problems will be limited if a better assessment of solvency and liquidity risks is performed on a regular basis and built into the bank's normal control processes – together with enhanced internal reporting routines and enhanced external disclosure.
- However, in cases of extreme distress, it can be argued that there is a wider public interest argument for maintaining confidentiality in order to preserve financial stability, which may necessarily involve some degree of confidentiality regarding an individual bank's circumstances and any undertakings to support it given privately by government or other public authorities, until such time as the position is stabilised. It may be that investors in banks have to accept that this potential loss of information is an additional risk they have to take into account when making economic decisions, and that this should be made clear.
- This is an important policy question that only the appropriate authorities can resolve. It cannot, and should not, be decided by individual banks or auditors, by standard setters or even individual regulators. We consider that, once it has assessed stakeholders' views from this consultation, the Panel should make a clear recommendation to public authorities on the course it believes should be followed.



- **The merits of a separate financial reporting and auditing regime for banks (paragraphs 235-236)?**
- We do not believe that it would be beneficial to have separate financial reporting and auditing regimes for banks.
- One of the difficulties with such a distinction would be how to draw the boundaries around a bank, when very often the entity is not a stand-alone bank, but a part of a broader financial conglomerate or other enterprise. For example, if a major supermarket group has a retail banking business, is the group considered a bank? If different financial reporting and auditing requirements are applied only to the banking division and not to the wider group, how does that integrate with group reporting and auditing?
- The principal points of difference in a separate financial reporting regime for banks might lie around the use of 'hidden reserves' and the use of 'dynamic' or countercyclical provisioning methods for impairment of financial assets. Our view is that these techniques should not be used in the financial statements prepared for capital market investors, since they mask the underlying financial performance of the entity concerned. They may be a basis for separate regulatory returns for prudential regulators, or be included in additional disclosure alongside the financial statements.

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

- We have no further comments to add.