



Governance in Brief

Your summary of the latest corporate governance developments

Headlines

- Preliminary recommendations from the Sharman Panel of Inquiry on going concern and liquidity risk.

Preliminary recommendations from the Sharman Inquiry on going concern and liquidity risk

In Brief: The Sharman Panel of Inquiry has provided a summary of the evidence it has received and set out its preliminary recommendations and conclusions.

The aim of going concern disclosures – 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 when significant companies fail.

Expectation gaps on the going concern assessment and reporting process – there is a need to harmonise, and to clarify, the common purpose of the going concern assessment and disclosure process both in the UK Corporate Governance Code and in accounting standards. The language in the Code should be reconsidered to determine whether the directors should state that the entity IS a going concern is too definitive.

The focus of the going concern assessment process – there is a need to focus on solvency risks, not only liquidity risks. This should include identifying risks to the entity's business model or capital adequacy that could threaten its survival, taking into consideration economic and business cycles. This consideration will be more qualitative and longer term in outlook than on liquidity risk. 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 – going concern reporting should be fully integrated with the FRC's Effective Company Stewardship proposals such 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 directors to evaluate going concern.

Auditor reporting on going concern – the Auditing Practices Board 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. In addition the Board should seek to encourage the International Auditing and Assurance Standards Board to accommodate this approach in the International Standards on Auditing (ISAs).

Banks and financial institutions – the Panel considered whether banks and other financial institutions are a special case given the intensity of their going concern risks. The Panel has considered whether there should be a separate disclosure regime for banks and their auditors on the going concern assessment but has concluded that the Bank of England, as the primary guardian of the public interest in financial stability, is ultimately responsible for such considerations. The report notes that some commentators may wish to provide a wider range of opinions on this matter.

The proposals are not accompanied by an impact assessment and this will need to be developed and considered in the light of the need for economic recovery and avoidance of cost burdens. Without an impact assessment and the detail of the proposed changes to the FRC guidance for directors plus illustrative examples, it will be hard to understand fully the potential implications of these recommendations.

There are obstacles to removing the need for an emphasis of matter in certain situations as this is embedded currently in the ISAs which the UK and Ireland have adopted in full. It is also in the US auditing standards applicable to SEC registrants. Further, the European Commission is expected to propose shortly that ISAs be adopted by all EU member states.

The concept of linking the going concern basis to not only liquidity but also solvency needs much further consideration. Changes to UK and international accounting standards would also be needed to implement fully the Report.

Date: 3 November 2011

Source: The Sharman Inquiry

Deadline for comment: 31 December 2011

Further info: <http://www.frc.org.uk/press/pub2656.html>

Time to take action

- Take time to consider the full implications of the Inquiry's proposals on your company and respond accordingly. The two month timetable to consider these proposals is extremely ambitious so it is important to take action sooner rather than later.
- It is likely that going concern disclosures will be a key area of regulatory focus for the forthcoming reporting season. Example going concern disclosures and suggestions for improvements can be found in the Deloitte publication 'Gems and jetsam – surveying annual reports'.
- Key considerations for your going concern assessments continue to be the ongoing financial crisis arising from the Eurozone, the fragile economic outlook, coping with high levels of inflation, the need to comply in full with the extant FRC guidance on going concern and the importance of stress testing.

On the horizon

- Further announcements from BIS in the early part of 2012 on the next steps to put proposed audit exemptions in place.
- Legislative proposals from the EC further to the Green Paper on corporate governance.

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