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31 December 2011

Dear Sir

Preliminary Report and Recommendations of The Sharman Panel of Inquiry into Going Concern & Liquidity Risks: Lessons for Companies and Auditors

By way of background, and to put our comments in context, Governance for Owners (GO) is an independent partnership between its executives and long term investors such as Railpen, CalPERS and IPGL. GO offers a number of investment management and shareowner services products, including:-

- The GO European Focus Fund that invests in a small number of European public companies where value can be added through exercising owners' rights to address key structural or strategic governance issues that have historically impaired company performance
- GO Stewardship Services that offer independent voting, corporate engagement and other advisory services on environmental, social, and corporate governance (ESG) matters.

We are delighted to offer our comments on the Panel's Preliminary Report. Our comments are generally supportive of the line of thinking developed by the Panel, albeit we do offer some additional suggestions in a couple of instances. We particularly support the idea of requiring solvency as well as liquidity to be part of the going concern process and that of requiring auditors to be required to in effect confirm that there is a reasonable basis for the director's conclusions on going concern

Q1 Do you agree with the Panel's overall conclusion that the going concern process and disclosures should be designed to encourage appropriate business behaviours?

One could hardly argue otherwise. However, the Panel's overall conclusion continues to include within the appropriate business behaviours "sustaining an environment in which economic and financial distress is recognized and acknowledged sooner rather than later". This begs the question of "recognized and acknowledged by whom, to whom?". Shareholders want boards to recognize the signs of looming economic and financial distress early enough to be able to act upon them in order to avoid such distress occurring or the auditors to tell them (the shareholders) if the board has not either recognized or acted upon early signs of trouble ahead. Shareholders in listed or public interest entities cannot micro

manage how that is done. In the absence of disclosure to the contrary, shareholders should be able to assume that the directors and the auditors both consider that it is reasonable to assess the steps the board is taking as having a reasonable likelihood of success in avoiding the undesired distressful outcome. It would not help financial reporting if excessive or premature disclosure of the steps being taken to avoid financial distress made its avoidance all the less likely. Financial reporting, in the area of going concern as in others, should be about outcomes and likely outcomes and risks thereto and not the minutiae of how they are achieved.

Q2 Do you support each of the five recommendations set out in Chapter 1?

The recommendation that BIS and the FRC establish better protocols to learn the lessons from business failure is sound in principle but the key element of anything new here is timeliness. Any apparent systemic control, risk mitigation, reporting, accounting or auditing failures need to be identified more quickly than at the end of all of the public enquiries, parliamentary hearings and BIS inspectors' reports that might typically take a decade to conclude. A more systematic approach that simply added another report on top of what occurs now and at the end of those processes would not necessarily be cost effective.

The Panel's second recommendation to seek greater harmony in the language relating to going concern in the Code, the Listing Rules and accounting standards is sensible. The attraction of a disclosure more nuanced than "is/is not" a going concern is also attractive to us. It might be more helpful for shareholders to be told by directors and auditors that in their respective opinions the board was sufficiently cognisant of the risks to going concern being faced by the company and that there was a reasonable likelihood of the actions being taken in light of those risks allowing the company to meet its liabilities as they fall due in the next year from the date of reporting and have assets greater than liabilities over a reasonable (specified?) period, i.e. continue as a going concern. Indeed we do not see why there should be much of a difference between the "working capital" adequacy tests done for capital raising and what companies and auditors should be doing every year as part of the going concern process. That there clearly is a significant difference at present is a major cause of the expectation gap discussed in the Panel's report.

We support the Panel's third recommendation that the FRC review the Guidance for Directors to require going concern assessments take account of solvency as well as liquidity, that solvency considerations are more qualitative and longer term and that stress tests with an appropriately prudent mindset should form part of the going concern consideration. We would favour additional disclosures when there is evidence to suggest that it may be some time before assets exceed liabilities. This occurs often in the aftermath of a refinancing when future profits are required to eliminate net liabilities or when there is a large pension scheme deficit. These situations are indicators of possible insolvency, which require an understanding of why the board and the auditors do not consider insolvency is likely. We do not think the special consideration recommendation in relation to environmental and community risks has been fully developed. Directors' duties under the Companies Act are fully set out therein and a partial emphasis of some of them here may well prove unhelpful in some circumstances. In our view, the Panel should either develop this thinking further by reference to all of the considerations directors must have regard to when evaluating whether an action or decision is in the long term interest of the company as a whole or drop

this partial consideration altogether. On balance, we think that the Panel has strayed beyond its subject of going concern into addressing the definition of director's duties, which is not necessary to deliver the rest of the Panel's recommendations.

The fourth recommendation to explore a change from providing going concern disclosures only when there are doubts about a company's survival to a more discursive disclosure of the basis for the directors' conclusions and risks to their correctness also find favour with us. Our suggestion above in relation to the Panel's second recommendation is consistent with this approach. We do not, however, underestimate the amount of work required to get workable guidance on this matter. It could all too easily lead to excessively long, boiler plate disclosures from which it would be difficult to judge what really mattered.

We also favour the fifth recommendation of the Panel to change the auditor reporting on going concern to a confirmation of a robust assessment process and that they have nothing to add to the directors' disclosures. We would, however, add that our suggestion above in relation to the Panel's second recommendation is also relevant here. We favour that the auditors be required to conclude that in their opinion the directors have reasonable grounds for their conclusions.

Q3 Should the scope of any final recommendations be applicable only to listed companies or also to other entities? If they should be applicable 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.

Whilst it is clear why shareholders in listed companies would benefit from the general improvement in and changes to going concern reporting, and that government might similarly want such rules applied to what they deem to be "public interest entities", the burden of work and disclosure for some smaller non public interest or listed entities may be excessive. We consider that the Panel should leave it to the FRC and BIS to deal with the extension of scope from listed companies and/or exclusion from scope of some entities as appropriate as part of other overall reporting considerations.

Q4 In relation to banks, do you have any comments on;

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

Our starting point here is to be against any general secrecy for banks. We have experience amongst our partners of auditing insurance companies and accepting houses which were under special Companies Act dispensations allowed to make use of "secret reserves" until well in to the 1970s. We do not see benefit for shareholders in such an approach. What is key here is to ensure an appropriate dialogue between boards, auditors and regulators (necessarily free from confidentiality constraints between them) such that the concerns of one party are shared with the others to ensure appropriate reporting. Where there is a concern that a required disclosure will tip a bank into distress, the right response is probably either (further) access to the Bank of England's Emergency Liquidity Assistance (ELA) or for the FSA to activate the Special Resolution Regime for Banks (SRR) rather than ease back on disclosure alone. Accordingly, we are against a separate financial reporting and auditing

regime for banks. The principles underlying the Panel's recommendations for a more nuanced or graduated reporting on going concern appear to us to be sufficient as a basis for reporting by all types of businesses, including banks. Admittedly, the detailed processes within banks or bank audits to apply those principles will differ from those of other businesses, but that is not an argument for derogations from the general regime or for a separate reporting regime.

We hope you find these comments helpful. Please contact us if you would like to discuss any of the points made above. Further information or eventual clarifications can be directed in the first instance to Eric Tracey, Partner (tel: + 44 (0)20 7614 4750, email: e.tracey@g4owners.com).

Yours sincerely

A handwritten signature in black ink, appearing to read 'Peter Butler', with a horizontal line underneath.

Peter Butler
Founder Partner and CEO

A handwritten signature in black ink, appearing to read 'Eric Tracey', with a horizontal line underneath.

Eric Tracey
Partner