TASK

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".

CONTRIBUTION IN REPONSE FROM:

Mira Makar MA FCA LRAD ARAD

Relevant Experience: 29 years

corporate recovery; turnarounds; decade plus Coopers & Lybrand, London, tax, treasury, financial instruments, corporate, M&A, cross border, compliance

decade plc CEO, FD, deputy chairman, professional services, business transformation, risk management, compliance and infrastructure delivery projects, telecoms (mobile/fixed), banking/insurance (product manufacture/wholesale/retail sales); public sector (central government)

public company principal investor

witness to matters under regulatory review and consequences of the absence of law enforcement

"Joe Public"

GLOSSARY/INTERPRETATION USED IN THIS RESPONSE:

Recessionary enviroment:	quarter on quarterly stagnant or reduced GNP
Short to medium term:	time in number of months for unemployment to fall to previous level at cycle peak, given stable/adjusted population size available for paid work
Credit crisis;	symptom of interdependence of financial firms: A crisis that occurs when several financial institutions issue or are sold high-risk loans that start to default. As borrowers default on their loans, the financial institutions that issued the loans stop receiving payments. This is followed by a period in which financial institutions redefine the riskiness of borrowers, making it difficult for debtors to find creditors
trading as a going concern	The commonly used basis of valuation of historic financial statements; to be contrasted to, for example, break-up valuation, with redundancy and closure costs and stock/WIP revaluations
auditor	statutory independent reporting by a public accountant on **historic** financial statements in accordance with Companies Act; FSMA 2000 etc
Serious economic criminals (SFO definition)	dishonest and greedy individuals who look like successful professionals/business people; SFO web site and output of conference published 14 December 2011 http://www.sfo.gov.uk/about-us/our-views/sfo-blog.aspx
supply chain	bankers insurers lawyers brokers public accountants auditors who supply services to plc directors and collectively comprise the supply chain to those charged with the governance of the enterprise

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.

1. FRC: learning lessons	This recommendation is primarily about the mechanisms that the FRC used to educate itself after the event. However: a) after the event is too late; arbitrage and speculation products are developed and marketed the whole time and learning about them after the event is no more that creating a history book; b) the FRC has correctly identified certain recurring themes, such as firms using audit to cross sell and partners being promoted on the basis of sales skill rather than being a "safe pair of hands", but it has no mechanism for doing anything with this data beyond publishing it; c) there is no evidence that Gateway does not work or that BIS has been asked by the FRC to assist its education and been turned away; d) the SFO has publicised a conference of law enforcers (14 December 2011) demonstrating co-operation and sharing experience by creating a profile of an economic criminal: there is no indication that the FRC was excluded from the invitations or the benefit of the output, published on the web-site.
2. FRC: investigation of corporate failures	There are plenty of economic historians who research the major corporate failures in history; the FRC is not a university or publicly funded research organisation and it is not appropriate that it should become one. The chasm that currently exists, is that there is no well trodden mechanism for law enforcement whilst the harm is being done, as well as a lack of prosecution: the decision is "wait for collapse" or "do something to avert it before it is too late".
3. FRC: Insolvency Practitioner's reports	There is no prima facie reason why the FRC ought not to be reviewing these as a matter of routine in any event eg BCCI, and it would be astounding if they do not. However there is a difference between gaining experience from long term civil servants in the Insolvency Service (and/or working on a "shared services" basis), and losing independence in regard the Administrators themselves, who are those who are, or ought to be, liable to sanction by the FRC as purveyors of assurance reports on historic financial statements, at whatever basis of valuation is appropriate. The "unfettered greed" identified by the business secretary and the financial speculation that has been so damaging is as manifest in the world of administration where "packaged administrations" are prevalent (apparently unlicensed and unregulated retail sales of manufactured financial product), and the licence of a few is used to generate revenues from the many who otherwise have no licence or personal risk or sanction. Law enforcement that is mandatory in law at the time the crime is committed is a different exercise to learning from accountants, who in any event, are themselves policed by the FRC.
FRC resources and training	It is not cost efficient to train individuals who are not law enforcers to become law enforcers; the FRC imposes levies on UK Plc and must be seen to be "earning" the appropriation from shareholders funds. This includes by the protection of directors who approve the payment of the levy from economic criminals (those dishonest and greedy persons identified by the SFO), to the extent it has a policing function and who must be prosecuted rather than fined if Joe Public (the directors and the market) are to be protected.

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.*	
4. Going concern	Whether the going concern basis of valuation is appropriate or not is a question of fact, not opinion: put simply, either the bills can be paid as they fall due, or they cannot
5. directors liability	the directors are responsible for the maintenance of records and preparation of proper accounts; these INCLUDE the auditor's report and policing that the auditor has complied with their duty to report (to those charged with the governance of the enterprise) and has reviewed the capital adequacy reviews by directors under the listing rules and companies act
6. purpose	The purpose is to determine whether the business can adopt a going concern basis of valuation or not and whether it has complied with liquidity ratios, eg banks and insurance companies
7. enterprise "is" a going concern	since this is a question of fact, any descriptive words are not capable of being meaningful either the bills can be paid as they fall due or they cannot
8. directors liability	directors are not underwriters and no educated director will either guarantee the resilience of the balance sheet or make a forecast
9. tinkering with the listing rules	the FSA has not to date prosecuted a public accountant under the Listing Rules for failure to properly review capital adequacy and report whether or not the financial statements (post capital adequacy review) agree with the underlying records (contracts, insurance and licences). Until it does so (reckless conduct under FSMA 2000, an auditor shall report etc), it has not "earned" the public credibility and confidence that warrant its views making any difference to decision makers
10. Talking	Public company finance directors, CEO's and victims of the lack of enforcement are important witnesses: the FSA and FRC can usefully identify operating guidelines where there is a presumption of enforcement and multiple authorisations before an enforcer is permitted either to close a file or impose a fine instead of prosecution: the FSA and FRC talking to each other will not achieve this

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.*	
11. Mindset	Capital adequacy forecasts are mechanical and do not require a particular mindset
12. Auditor	The auditor, by contrast, does require a particular mindset, that is to identify risk, to report on risk and to manage risk on an independent basis With the move to exceptions based reporting, risks are filtered out and therefore the result can be predicted that the risks are missed or not understood
13. Enviroment/community	The responsibility of the FRC is to ensure the honesty of the accountants on whom the directors depend: the greed and dishonesty of the economic criminals identified by the workshop held by the SFO is a matter for law enforcement. Without enforcement capital will continue to flee from the UK
14. liability	The respective liabilities and obligations of director and auditor are set out in the Companies Act: it is important to avoid exercises of attempts at risk shift by developments of more red tape from auditor to director- we are at the stage now, and have been for some years, where companies communicate through lawyers to the auditor and the auditor will not report save through lawyers: this represents and organised market acting in self interest against a voiceless Joe Public and is not sutainable

Recommendation 4

*The Panel recommends that, in taking forward its w*ork 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 mater*ial 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 standar*ds and guidance for directors *and auditors accordingly when the ECS proposals are finalised.*

15. positive reporting	Defects in reports by auditors were high lighted in the FRC/FSA consultation, in particular the auditor is not obliged to report positively: (i) that he has seen the books and records (ii) that the financial statements agree with the underlying accounts (iii) that he has reviewed going concern and received all the information and explanations he needs (iv) that the books and records are sufficient to establish the financial trading position at all times
16. focus on going concern	Capital adequacy reviews are part of routine monthly diligence and reviews with the external auditor in public companies at least: if not the auditor must make an adverse report Where there is a reporting delay, routinely capital adequacy reviews are updated
17. confirmation of a robust risk assessment	This is already the subject of an adverse report by the auditor under the companies act (if appropriate); and the fact of the review by the auditor under the Listing rules: a director cannot possibly know whether the auditor has looked at the underlying records and validated the statements against them. Therefore the only "confirmation" is that from the auditor not the director
18. explanation of material risks	The generic risks faced by an enterprise are addressed in the prospectus and analysts' research notes; the specifics are company confidential and would not ordinarily be disclosed. Risks as whether or not the auditor has looked at the books, agreed them to the statements and understood what he is looking at are not within the knowledge of directors

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.*

19. auditor's reports	The Companies Act already requires reporting on the basis of preparation of financial statements (going concern); the auditor must report if the underlying truth in contracts/records is not in accordance with those statements; FSMA 2000 listing rules require the auditor to check that there is a going concern review; and the auditor's internal controls/compliance audit requires
20. process reports	The auditor does nor audit the internal risks control systems but does carry out a compliance audit: how far apart these are depends on the particular enterprise The result of compliance audits is part of the auditor's confidential working papers; reports on defects are in the letters to management Auditors do not typically relish reporting on the audit of a process and can be predicted to say "no" (unless a special assignment)
21. outcome	"nothing to add" is a meaningless statement as it does not say whether the auditor has done anything to put himself in the position to have anything to add eg "I have looked" "I have agreed the numbers" etc
22. standard	If the auditor is not going to release their working papers and neither director nor auditor is going to guarantee the balance sheet, drafting changes to standards will make no difference



31 December 2011