PIRC

Pensions & Investment
Research Consultants Ltd

6th Floor, 9 Prescot Street
London E1 8AZ

Telephone +44 (0)207 247 2323
Fax +44 (0)207 680 4081
Email info@pirc.co.uk

www.pirc.co.uk

The Sharman Inquiry
c/o Marek Graboswski
5th floor, Aldwych House
71-91 Aldwych
London
WC2B 4HN

30th June 2011

Dear Sirs

Sharman Inquiry – Going concern

PIRC welcomes this consultation which is well timed. PIRC concurs with the conclusions of the House of Lords Economic Affairs Committee that the banking crisis demonstrated a dereliction of duty of auditors, and that imprudent accounting standards and practices were a major contributory factor in that crisis.

PIRC has for many years seen audit as central to shareholder protection, as well as shareholder information in order to exercise class rights and has been disappointed by:

- banks having failed within a year of having received clean going concern opinion, hence failed assurance on that aspect of the audit,
- dividends being declared off accounts for the AGM to approve, and then cancelled, hence failed assurance on the reliability of the audit for that purpose,
- dividends paid, with rights issues shortly after, with the bankruptcy of the bank then occurring shortly after that, hence failed assurance on both the annual accounts and the prospectus which relied on the annual accounts.

PIRCs guidelines have for several years cited the supreme case law on the objective of the audit, "Caparo,[1]" as setting the benchmark for the **contractual** expectation of auditors, as it is clear that the auditing profession has actively engineered an "expectations gap" concept to occlude the full legal duty that is in fact the statutory

[1] Caparo v Dickman (House of Lords 1990). The duty of care is to the company to protect it, and its shareholders as a class.

contract. This has been achieved by creating a different **regulatory perception**[2] of the audit product. The legal position is that the audit is attached to accounts in order to provide reliable intelligence to:

- hold the board to account and reward it properly
- protect the company itself, from fraud, or error, such as paying dividends out of capital

It is most disappointing that none of the post crisis outputs of the FRC have focused on the legal position of the audited accounts but matters peripheral to that. This enquiry in focusing on going concern, seems to, in part, to try to remedy that.

Faulty going concern opinions on banks

In the global financial crisis, going concern opinions were faulty for both bank holding companies which had invested in bankrupt banking subsidiaries, and for the bankrupt banking subsidiaries themselves.

PIRC has identified the following bankrupt holding companies

- Northern Rock plc *
- Bradford and Bingley plc *r
- HBOS plc #r
- Royal Bank of Scotland Group plc *r

Further to that, were the bankrupt subsidiaries:

- Ulster Bank Limited * (under RBS Group plc)
- Royal Bank of Scotland plc * (under RBS Group plc)
- Bank of Scotland plc * (under HBOS plc)

* dividend paid, in year of collapse
\# dividend declared and then cancelled, in year of collapse
r public rights issue in first half of 2008

(All of the above lost capital in excess of 100% of what had last been shown as shareholders' funds in their audited accounts (2007 accounts, except for Northern Rock which was 2006).)

On the basis of the Caparo definition of accounts and audit quality, which is fundamental to those businesses as going concerns (unless it is made clear to the members that it is not a going concern), all of the above entities failed that test, and would prima facie, appear to be audit failures.

[2] The regulatory perception is that accounts are merely "to be useful to users", decision usefulness, a vague objective to no distinct class or purpose.

Faulty consolidation practices obscuring risk

PIRC has also identified problems where banking companies had combined in their individual accounts the assets and capital of Master Trusts - which had calls on the capital of the bank - without accounting for, or disclosing, onerous covenants which led to contingent capital calls on the capital of the banking company. Two competing interests were in fact mixed up.

Some of these covenant terms were available to market participants, and some correctly deduced the fatality these covenants would cause, but these were not addressed by either the accounts, the audit opinion or the going concern review, and hence neither the directors or shareholders ("the company") knew what was going on. This could have been avoided, were Master Trusts rightly consolidated in the group accounts, but not consolidated in the individual accounts of the bank.

Banks which were going concerns

PIRC notes that the following banks survived, and were going concerns:

- HSBC plc
- Standard Chartered plc
- Barclays plc
- Lloyds TSB (would have survived excluding the impact of the acquisition)
- NatWest Bank plc (its accounts show that it did not make capital critical losses)

PIRC therefore observes that the banking crisis in the UK (banks requiring tax payer support) was not a universal exogenous event, but was caused by those banks that were in fact bankrupt, but had received clean audit opinions on a going concern basis.

Accounting standards and the audit

PIRC participated in the Audit Quality Forum ("AQF") set up by the ICAEW under the then DTI in 2005. It is quite clear from reviewing the publications from the AQF[3] of that period that accounting standards were moving from the objective still required by the law, of stewardship (for the benefit of the company), towards the different objective of "decision usefulness" (for "users").

The accounting framework being pursued and auditing framework required by company law was clearly set out in the AQF Audit Purpose Document.

"The group believes that further consideration of the potential differences between International Financial Reporting Standards as a reporting framework and the purpose of the audit under the current UK legal framework (and future framework) by

[3] AQF Audit Purpose 2005

an appropriate forum would be helpful in understanding these differences and what the likely implications may be."

It was noted then that accounting attributes were moving away from prudence towards "neutrality" and allowing for loss deferral (not booking contingent liabilities or provisions), objectives which are in fact not only inconsistent with stewardship, but also making it difficult to identify if a company is in fact not a going concern when the accounts make it appear that it is.

Given that creditor and shareholder funding requires a reliable capital base, and the only way for an outside party to determine that is from the accounts, leaving out losses (or including unreliable profits) makes the going concern position at best speculative.

PIRC therefore does not understand how accounts prepared in accordance with a financial reporting framework (IFRS) in which the going concern position is speculative – for "users" to determine things – can be a basis for directors and auditors to form an opinion on going concern.

Being a going concern requires a stable balance sheet and clear profit/loss trend.

Reaching a rigorous going concern conclusion requires reliable audited information in order to reach that conclusion. If IFRS information is being fed up the reporting chain to boards, and auditors, and also via other audited subsidiaries' accounts, it is difficult to see how the directors and auditors can form a robust opinion on the going concern status of the company or the group. If the auditors are receiving from other auditors, audited information in IFRS only form, there is no information passing up the chain about the losses that IFRS is leaving out, or overvaluations that IFRS is leaving in.

PIRC notes that the fundamental common law accounting principles relevant for declaring dividends are:

- prudence,
- no unrealised profits,
- matching all costs relating to the period,
- no netting of asset and liabilities or profits and losses,

As information and assurance is required for dividend purposes on the above basis, to avoid making distributions out of capital, it is a clear corollary that in order not to deplete capital altogether (such that liabilities>assets), that similar principles apply in order to determine whether a limited liability company is in fact a going concern or bust.

PIRC notes that all of these principles are "musts" in the form and content required of Companies Act (but not IFRS) accounts.

Other examples, of going concerns and problems with business-funding models

PIRC has consistently looked at other companies that claimed to be going concerns and were not. In terms of going concern as well as the balance sheet and profit trend, it is also important to look at the business model and its sustainability

Southern Cross plc. As a holding company Southern Cross plc had two principal assets. Investments in loss making subsidiaries of £3,000 (these subsidiaries had made acquisitions of care homes with underlying negative tangible net worth of £183m) and unsecured loans to those subsidiaries of £238m at 4% interest.

It is quite difficult to conclude how Southern Cross plc (parent company) was in fact a going concern given that funding model. Further, nothing in the going concern statement made by the company makes any reference to the funding structure of the company itself.

Despite that being the biggest going concern risk to the company (and the group). It would be interesting to understand whether the directors and auditors of Southern Cross plc ever considered whether any other party would be prepared to extend finance to loss making companies on such generous terms, and if not, why not.

The lifecycle of Southern Cross has not been economically beneficial for shareholders.

Farepak (European Home Retail plc). This was not dissimilar to Southern Cross, other than the fact that in this case it was a highly cash generative subsidiary, Farepak Food and Gifts Limited. Farepak lent £46m, on unsecured terms to its parent company which used the cash to make acquisitions, which failed.

Again, the funding model, on which the business model depended, does not appear to have been a going concern consideration at all.

Alfred McAlpine plc. From the group accounts it appeared that the Alfred McAlpine plc group was profitable. In the parent company accounts it appeared that Alfred McAlpine plc was investing – by increasing the intercompany balance – in its subsidiary McAlpine Slate Limited

However, it transpired that McAlpine Slate was in fact loss making, and its management was creating the impression of investment, so as to justify receiving funding from its parent.

Furthermore it was creating cash flow, by selling forward slate and selling slate at discount prices inorder to preserve the appearance of margins.

Both the assets of the company and the group were vastly overstated. As in the case of the banks, the detection of the problem was the behaviour of secondary markets, the price of slate dropped, and it was only that which caused the fraud to be discovered. The quarry's resources had been significantly depleted by the over-extraction. There was a significant loss of employment in Snowdonia.

It is clear in just 4 examples that in getting the going concern assumption wrong caused not merely significant investor loss, but also raises significant public interest issues:

- systemic banking failures requiring taxpayer support,
- loss of Christmas savings in the case of Farepak,
- significant problems in healthcare,
- problems in construction and the North Wales economy.

Conclusion

PIRC believes that it is vital that the Panel resolves the problem of how in using IFRS companies themselves and their subsidiaries can satisfy the going concern question. Particularly in the case of banks, where there are no privately testable covenants, but the reliability of the accounts themselves are the covenant for the providers of finance.

PIRC also believes that the Panel should recommend that the Auditing Practices Board considers an auditing standard dealing with the issues relating to parent companies accounts, including the going concern position.

Yours sincerely

Alan MacDougall
Managing Director
AlanM@pirc.co.uk
Tel: +44 (0) 20 7392 7870
Fax: +44 (0) 20 7488 4076
Mobile: +44 (0)7889 247871