



FINANCIAL REPORTING COUNCIL

**AN UPDATE FOR DIRECTORS OF COMPANIES THAT ADOPT THE
FINANCIAL REPORTING STANDARD FOR SMALLER ENTITIES
(FRSSE): GOING CONCERN AND FINANCIAL REPORTING**

MARCH 2009

Introduction

Economic difficulties are having a profound effect on the availability of credit for many individuals and companies. This means that directors of companies of all sizes may need to take more care in determining whether they:

- (a) should prepare their annual accounts on a going concern basis; and
- (b) need to make additional disclosures in their annual accounts.

The update is intended for directors of smaller companies that qualify for the small companies' regime in the Companies Act and choose to apply the Financial Reporting Standard for Smaller Entities (FRSSE). The Financial Reporting Council (FRC) does not anticipate any significant increase in smaller companies preparing accounts other than on a going concern basis, but does expect that many accounts may benefit from a short note explaining how credit market and other economic difficulties have an impact, if any, on the company's particular circumstances.

The purpose of this update is to assist directors of smaller companies by:

- (a) summarising the criteria that must be met in order to produce their annual accounts on a going concern basis; and
- (b) identifying some basic procedures that may be used to support their conclusions on going concern.

The FRC issued "An update for directors of listed companies: going concern and liquidity risk" in November 2008 which may also be helpful to directors of smaller companies, particularly those that use UK GAAP rather than the FRSSE.

Companies Act 2006 – requirements for smaller companies

Directors of smaller companies are required by the Companies Act 2006 to prepare annual accounts that give a true and fair view. When preparing annual accounts directors are required to decide if it is appropriate to prepare them on a going concern basis

Smaller companies may elect not to have an audit and/or may file abbreviated accounts with Companies House. However, smaller companies are required to produce annual accounts that give a true and fair view and these may be needed to be given to customers, banks and others to enable business to continue.

Going concern and the FRSSE

The FRSSE provides that accounts shall not be prepared on a going concern basis if the directors determine that they intend to cease trading, or that they have no realistic alternative but to do so. In practice, it is very rare for accounts not to be prepared on a going concern basis.

The FRSSE also provides that directors shall:

- (a) assess whether there are significant doubts about the entity's ability to continue as a going concern;
- (b) disclose any material uncertainties, of which they are aware in making their assessment; and
- (c) disclose where the period they have considered in making this assessment has been limited to a period of less than one year from the date of approval of the annual accounts.

Making an assessment

Assessment of the use of the going concern basis of accounting involves making judgments, at a particular point in time, about future events which are inherently uncertain. Those judgments are valid only at the date of approval of the annual accounts. The fact that directors prepare accounts on a going concern basis is not intended to and does not guarantee that a company will continue in existence until the next annual accounts are published or even until the next balance sheet date. Doubts about the ability of a company to remain as a going concern do not necessarily mean that the company is, or is likely to become, insolvent.

This update suggests procedures that directors may wish to carry out in assessing whether it is reasonable to use the going concern basis of accounting and include additional disclosures in annual accounts. It does not introduce any new requirements. As a result, it is not expected to give rise to an increase in the amount of work that is necessary for directors of smaller companies to prepare their annual accounts beyond that already required. However, when compared to prior years, additional work is likely to be necessary due to the difficult economic conditions that are now present.

Current market conditions

Not all companies require bank credit for their financing. In the current environment, those companies that do require bank credit are more likely to be able to secure bank credit if they are:

- (a) financially well managed;
- (b) have a robust business plan, including cash flow forecasts; and
- (c) regularly update and discuss this plan with their bankers and other lenders.

Annual accounts published within a reasonable period of a company's year end also provide supporting evidence that a company is well managed.

The effect of current market conditions on individual entities requires careful evaluation. However, it should not be assumed that the general economic situation at the present time of itself means that a material uncertainty exists about a company's ability to continue as a going concern.

Potential procedures for assessing going concern

Directors may approach their going concern assessment in different ways. The first objective is to satisfy themselves that they have reasonable grounds for concluding that it is realistic for the company to avoid liquidation within twelve months of the date of approval of the financial statements. The second objective is to consider whether specific disclosures should be made.

The following section identifies some procedures that directors may wish to consider when assessing the appropriateness of the use of the going concern basis of accounting in accordance with the requirements of the FRSSE. It should not be used as a checklist since there may be other procedures which are relevant for a particular company.

Possible procedures and resulting disclosures

The extent of the procedures undertaken by directors should depend on the individual company's specific facts and circumstances. For example, directors of a company with significant borrowings and uncertainties about future sales will need to conduct significantly more analysis than for a company with substantial cash balances and a committed order book.

1. Directors should prepare a budget, trading estimate, cash flow forecast or a similar analysis covering the period up to twelve months from the date of approval of their annual accounts, or for a longer period.

Note: Directors are required by the FRSSE to disclose if the period they have assessed is shorter than 12 months from the date of approval of their accounts.

2. If directors decide to prepare a budget, trading estimate or cash flow forecast they may:
 - (a) analyse income, costs or cash flows by month or by quarter. This may depend on the cyclical nature or otherwise of the business;
 - (b) identify the most significant assumptions that underlie their forecast and prepare a short note on those assumptions;
 - (c) identify reasonably possible adverse changes to income, costs or cash flows; and
 - (d) consider whether there is a need to take action, for example by negotiating better terms with creditors, including HMRC.
3. Directors may summarise the key conditions contained in any existing bank facilities or credit arrangements made available by suppliers and consider the impact of reasonably possible adverse changes in these terms and conditions.
4. Directors may discuss with their bankers and other lenders whether it is reasonable to assume that loans and/or overdrafts will continue to be available. The absence of confirmations, particularly in the current environment where banks are having to deal with a significant increase in workload, does not of itself necessarily cast significant doubt upon the ability of a company to continue as a going concern.
5. Directors then assess all of the information that they have obtained and make and document their decision on whether to use the going concern basis of accounting for preparing their annual accounts.

Note: If directors conclude that there are material uncertainties of such significance that they have no realistic alternative but to cease trading they should not adopt the going concern basis of accounting.

6. Directors then assess the need for disclosures about uncertainties in their annual accounts if they represent material uncertainties about the ability of the company to continue as a going concern.

Note: The use of the going concern basis of accounting is fundamental to a company's balance sheet. If directors have included a specific disclosure about going concern in their annual accounts then that note should also be included in any abbreviated accounts filed at Companies House.

Practical examples

The following two examples illustrate the nature of disclosures that could be appropriate to a smaller company. However, such disclosures should always be tailored to the specific facts and circumstances of each company:

“There has been a significant reduction in requests for estimates for new decorating work and the directors expect sales to reduce significantly next year. However, costs are expected to reduce accordingly and the company should be able to operate within its overdraft. The directors are not aware of any reason why the overdraft facility should not be extended. As a result they have adopted the going concern basis of accounting.”

“The company has a contract for all of its available consulting capacity for the next six months and negotiations are at an advanced stage for a three month extension. The director believes that the company will be able to maintain positive cash flows for the foreseeable future. As a result the going concern basis of accounting has been adopted.”

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