



FINANCIAL REPORTING COUNCIL

**CHALLENGES FOR AUDIT COMMITTEES
ARISING FROM CURRENT ECONOMIC CONDITIONS**

NOVEMBER 2009

Introduction

The current economic outlook appears to be less depressed than this time last year. However, significant economic risks remain and will present challenges for many audit committees during the 2009/10 reporting season. Past experience shows that insolvencies have increased after the technical end of recessions as companies run out of working capital. Such conditions mean that the next twelve months are likely to be particularly difficult for management and may increase the risk that annual reports and accounts misreport facts and circumstances and contain uncorrected errors and omissions.

The attached questions seek to identify issues that will be particularly relevant to the work of many audit committees over the next few months. This publication does not establish any new requirements.

Specific risks and uncertainties

All companies are likely to be experiencing the effects of the recession in one form or another, but these conditions impact different companies in different ways. Useful insight can often be gained by observing the strengths and weaknesses of competitors and comparing their performance to that of the company.

Companies may have found it necessary to change their business models in order to improve cash flow or to manage extreme competitive pressures. Such changes may have included amendments to terms of trade and/or the way in which goods and services are processed and delivered. There is also a higher likelihood of companies entering into innovative transactions which require careful analysis to ensure that appropriate accounting policies have been identified and applied. Where such changes are present, they are likely to necessitate reconsideration of accounting policies and the effectiveness of the system of internal control.

Reliance on assumptions and models for cash flow and valuation information

Whilst market conditions appear less volatile than last year, many companies will still need to consider a wider-than-normal range of reasonably possible outcomes when performing sensitivity and scenario analysis on the cash flow projections supporting both asset valuations and impairment assessments.

The increase in the range of reasonably possible outcomes places additional pressure on the judgments needed to evaluate illiquid asset values. Audit committees are likely to want a clear understanding of these judgments and may require more detailed information and analysis.

Principles-based accounting and reporting standards rely on being applied in a constructive and transparent way with a focus on useful communications, not just the minimum necessary to comply with laws and regulations.

Audit committees are likely to want to be convinced that key judgments are supported by a greater degree of rigour and analysis than in more normal circumstances and to consider how such matters have been explained in the annual report.

Liquidity risk and going concern

One aspect of this dependence on cash flow forecasts is the work necessary to assess going concern. The Financial Reporting Council (FRC) has just published revised guidance for directors on going concern and liquidity risk (<http://www.frc.org.uk/publications/pub2140.html>).

Heightened liquidity risk will necessitate greater attention to the key assumptions and processes that lead to cash flow forecasts. In some cases, detailed consideration will need to be given to determine whether there are material uncertainties leading to significant doubt about whether the business is a going concern.

Many companies have responded to the FRC's call for improved disclosures in 2008/9 and linked their going concern statement required by the Listing Rules together with the liquidity risk and supporting analysis required by International Financial Reporting Standard 7 - Financial Instruments: Disclosures. The FRC continues to attach importance to the quality and clarity of these disclosures.

Year-end planning considerations

Given the increased economic pressures, audit committees may need to consider the possible impact of an increased risk of error or omission or manipulation of the annual financial information.

Effective systems are particularly vital in order to manage an increased risk of error, omission and fraud when management and supporting finance teams are under abnormal pressures. This may necessitate a re-examination of systems and controls over key reporting areas. Pending the outcome of the FRC's recently announced review of market practices in relation to the provision of internal audit services by external auditors <http://www.frc.org.uk/press/pub2157.html>, audit committees should be cautious about the engagement of auditors to provide services which may compromise the boundaries between internal and external audit services.

External commentary is another key source of information to help alert the audit committee to business issues. Examples include questions raised about prior period financial statements which could indicate areas requiring attention in the current year.

Audit committees are likely to find it useful at the planning stage to have access to press comments about prior period financial reports together with a briefing on any correspondence with regulators such as the Financial Reporting Review Panel and a copy of any comment letter provided by the Audit Inspection Unit to the company's auditors.

2009/10 Corporate Reports Key Questions for Audit Committees

Area of consideration	Key questions
<p><i>Assessing and communicating risk and uncertainties</i></p>	<p>Has the audit committee considered whether the Board may need to amend the group strategic plan including expectations of future growth and the group's ability to sustain or modify its business model?</p> <p>Is the committee satisfied that the group has monitored the effects on the business of the continued volatility in the financial markets and reduced supply of credit, including its exposure to liquidity risk and customer and supplier default risk?</p> <p>Has the Board set out in the annual report a fair review of the company's business and how the business may have been changed to address the effects of the recession?</p> <p>Is the committee satisfied that the business review presents the principal risks and uncertainties that most concern the Board in a fair and transparent way?</p> <p>Has the committee considered whether the audited financial statements describe fairly all of the key judgments about the application of accounting policies and the estimation uncertainties inherent in assets and liabilities?</p> <p>Have all relevant issues that have concerned management during the year and that have been drawn to the attention of the board and/or the audit committee been considered for disclosure?</p> <p>Has the committee considered whether there is a need for additional disclosures about company circumstances, such as going concern issues, in preliminary announcements or other regulatory reports before the annual report is published?</p>

2009/10 Corporate Reports Key Questions for Audit Committees

<p><i>Reliance on models for cash flow and valuation information</i></p>	<p>Has the audit committee considered the processes in place to ensure that appropriate procedures and controls have been applied to the group's use of models to generate cash flow and accounting valuation information, including the choice and consistent use of key assumptions?</p> <p>Has consideration been given to the changes in those assumptions made since last year and whether those changes are consistent with external events and circumstances?</p> <p>Do models adequately address low probability but high impact events? Has management considered which scenarios are the most challenging for the company?</p> <p>Is the audit committee satisfied that appropriate sensitivity analysis has been conducted, by flexing assumptions, to identify how robust the model outputs are in practice and are the assumptions free from bias?</p> <p>Where assets are not traded, perhaps because markets are no longer active, is the committee satisfied that appropriate additional procedures have been undertaken to estimate fair values through the selection of market-based variables and the use of appropriate assumptions?</p> <p>Where models have been used to estimate the value of assets which must be tested for impairment, is the committee satisfied by the procedures adopted to estimate cash flows and that the appropriate adjustments have been made for risk?</p> <p>Are the assumptions that underlie any impairment tests consistent with internal budgets and forecasts and with how the prospects for the business have been described elsewhere in the annual report?</p>
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2009/10 Corporate Reports Key Questions for Audit Committees

<i>Liquidity risk and going concern</i>	<p>Is the audit committee satisfied by the process that the Board has conducted to conclude that the financial statements should be prepared on a going concern basis? Was reference made to the revised guidance from the FRC: “Going Concern and Liquidity Risk: Guidance for directors of UK companies 2009”?</p> <p>Is the committee satisfied that proper consideration has been given to cash flow forecasts prepared for at least, but not limited to, twelve months from the date of approval of the financial statements including an analysis of headroom against available facilities and that all available information about the future has been taken into account?</p> <p>Has the committee considered whether there is a need to extend the cash flow forecast exercise to evaluate issues that may arise after the end of the period covered by the initial budgets and forecasts?</p> <p>Is the committee satisfied that appropriate evidence has been obtained about the group’s ability to secure new or to renew existing funding commitments?</p> <p>Has the committee considered an analysis of the terms of current banking facilities and covenants, and has this analysis identified risks that need to be addressed? If so, are plans in place to manage those risks?</p> <p>Is the committee satisfied that full consideration has been given to guarantees, indemnities or liquidity facilities that have been provided to other entities that the group may be called on to honour? Has management considered whether the group has the resources to meet such obligations should they arise?</p>
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2009/10 Corporate Reports Key Questions for Audit Committees

<p><i>Year-end planning considerations</i></p>	<p>Has the audit committee considered how it should respond to any heightened risk of errors, omissions or manipulation of reported financial results or balance sheet presentation? Has it assessed how these risks have been mitigated?</p> <p>Is the committee satisfied that appropriate plans are in place to make a considered assessment about the use of the going concern basis of accounting at the date of approval of the annual report and accounts?</p> <p>Does the committee need further analysis of how the business has been affected by the recession? For example, if the terms of trade have been changed has this resulted in a reconsideration of the system of internal control and how accounting policies have been selected and applied? In particular, if sales terms and conditions have been changed has the company's revenue recognition policy been reviewed and does it need to be amended?</p> <p>Has the company changed its business in a way that would increase the demands on the group finance function and its need for specialist skills? If additional resources are required, has a plan to increase resources been made and implemented?</p> <p>Where an internal audit function exists, has the committee considered whether it wishes internal audit to conduct additional work up to or at the year end? Is the committee comfortable with the boundary between internal and external audit ?</p> <p>Has consideration been given to any recommendations for improvement arising from prior year annual reports from the press or regulatory agencies, including the Financial Reporting Review Panel and the Audit Inspection Unit?</p> <p>Has the committee considered whether the group audit plan has been updated to address current risks and any changes to the business? Have the external auditors allocated sufficient additional and experienced resources to address heightened risks and, if not, are negotiations scheduled to secure additional commitments?</p>
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