



**FINANCIAL REPORTING COUNCIL**

**GOING CONCERN AND LIQUIDITY RISK:  
GUIDANCE FOR DIRECTORS OF UK COMPANIES**

**EXPOSURE DRAFT**

**MAY 2009**

The FRC welcomes the views of all stakeholders interested in corporate reporting.

The Exposure Draft asks for responses to a number of questions. However, commentators should not feel that they are either constrained by those questions or required to answer all of them. It will assist collation of views if the questions are used to structure responses.

Comment letters should reach the FRC by **28 August 2009**. It would be particularly helpful if they are sent as a Word file attachment to an e-mail to: [s.leonard@frc-apb.org.uk](mailto:s.leonard@frc-apb.org.uk)

If this is not possible please send letters of comment to:

**Steven Leonard**  
**Financial Reporting Council**  
**5th Floor**  
**Aldwych House**  
**71-91 Aldwych**  
**LONDON WC2B 4HN**

All responses will be regarded as being on the public record unless confidentiality is expressly requested. All public responses will be published on the FRC's website. If you wish your response to be treated as confidential you should request this explicitly in your letter.

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## **Background and reasons for this Exposure Draft**

### **The going concern issue**

Whether a business is a going concern is a fundamental conclusion that needs to be reached when preparing financial statements. The difference between financial statements prepared on a going concern basis and financial statements prepared on another basis can be very substantial. Making an assessment of whether to prepare financial statements on a going concern basis involves reaching a reasoned conclusion based on the specific facts and circumstances that exist at the date the financial statements are approved. Judgment is needed about the extent and nature of the procedures to be carried out to achieve this objective and the consequent disclosures.

Early in 2008 the Financial Reporting Council (FRC) recognised that going concern was a major accounting and auditing issue that would benefit from more up-to-date guidance to reflect the challenges arising from difficult economic circumstances. Going concern requirements are referred to in both UK GAAP and IFRS, however, these accounting standards provide little guidance about the process that should be undertaken or guidance about how to link together the various disclosure requirements about going concern and liquidity risk that they require to be made.

The existing “Going Concern: guidance for directors of listed companies” was published in 1994 (the 1994 Guidance) and some questions had been raised about how it linked to IFRS and whether the suggested procedures remained appropriate. As a result in September 2008 the FRC published a Consultation Paper “Going Concern and Financial Reporting: Proposals to revise the guidance for directors of listed companies” (the Consultation Paper) and in November “Going Concern and Financial Reporting: An Update for Directors” (the Update). The Update addressed both going concern and the need for disclosures about liquidity risk.

The attached Exposure Draft forms part of the FRC’s continuing response to these challenges. The FRC is seeking to ensure that going concern assessments are made with appropriate diligence and that going concern disclosures are balanced, proportionate and understandable in the circumstances prevailing at the date of approval of annual and interim financial statements.

### **Responses to the Consultation Paper and other feedback**

We received 20 helpful comment letters in response to the Consultation Paper and significant oral feedback on the Update at a number of meetings held with market participants. In particular, the feedback supported the FRC integrating the material in the Update with the 1994 Guidance.

The Consultation Paper identified that IFRS and the 1994 Guidance require directors to make similar disclosures about going concern but that their threshold points for triggering such disclosures were different. The 1994 Guidance requires disclosure where directors have identified factors which cast doubt on the ability of a company to continue in operational existence, whilst IFRS requires disclosure where directors have identified material uncertainties that cast significant doubt about the ability of the company to continue as a going concern. The comment letters we received encouraged us to seek ways to reduce the inconsistency between the different thresholds for disclosures that directors might be required to make.

## **The Exposure Draft**

The Exposure Draft brings together the Update and the 1994 Guidance and draws on the experience gained in recent months. The format and style of this Exposure Draft is significantly different to the 1994 Guidance, being more principles-based. However, it follows the same practical approach to making a going concern assessment and then making appropriate disclosures. The FRC believes that its impact will be to support directors in making high quality assessments of going concern and providing effective disclosures without increasing the costs for companies or users of financial statements.

The Guidance set out in this Exposure Draft will remain in place for a number of years. Consequently it has been developed to take account of a range of economic environments in which a going concern assessment might be made. The Guidance does, however, incorporate the lessons that have been learnt during the recent period of economic difficulties.

## **Questions for comment**

### **Coverage of all UK companies**

The 1994 Guidance was written to assist directors of listed companies. However, recent events have resulted in requests for the FRC to publish guidance that could be applied by directors across the full spectrum of UK companies. This Exposure Draft seeks to achieve this objective and addresses the issue of going concern for companies of all sizes including smaller companies that adopt the Financial Reporting Standard for Smaller Entities (FRSSE). The Guidance has been drafted on the basis of "think small first" and consequently comments relevant to smaller companies are addressed at the beginning of each section.

***Question 1: Do you agree that the FRC should provide guidance on going concern relevant for directors of all companies? If so, do you believe that the Exposure Draft achieves this in a reasonably balanced way?***

### **Introduction of principles**

The Exposure Draft follows more closely the style and format of other guidance for directors issued by the FRC, rather than the style and format of the 1994 Guidance. In particular, the sections have been reorganised and now begin with a principle supported by application guidance.

***Question 2: Do you agree with the principles as drafted? If not how would you amend them?***

### **Disclosures where there are doubts about the ability of a company to continue as a going concern**

The Consultation Paper identified that directors might need to consider four possible conclusions when evaluating the results of their deliberations about going concern. This was a consequence of adding into the Guidance the requirements that had been introduced by IFRS that disclosure should be made where directors identify "material uncertainties that give rise to significant doubt about the ability of a company to continue as a going concern".

A substantial majority of commentators argued that the Guidance should provide for three rather than four conclusions, being:

- “clean” going concern conclusion, i.e. there are no material uncertainties;
- “qualified” going concern conclusion where the directors believe there are material uncertainties; and
- use of a basis of accounting other than going concern.

However, commentators were split as to whether the additional disclosures should follow the IFRS requirement or the requirement in the 1994 Guidance.

The Exposure Draft proposes three conclusions. The FRC is not able to change the requirements of IFRS and so this proposal seeks to deliver better convergence of UK practice, IFRS and auditing standards by proposing that a qualified going concern conclusion should be expressed only where “material uncertainties leading to significant doubt” have been identified by the directors.

*Question 3: Do you agree with the three conclusions? If not, please explain what alternative you would suggest?*

#### **Half-yearly and interim financial statements – period of the going concern review**

The FRC believes that there is merit in adopting a consistent approach to the disclosure of the review period for both annual and interim financial statements that give a true and fair view. Paragraph 55 of the Exposure Draft, therefore, requires directors who apply this Guidance to disclose when their going concern review has not extended to a period of at least twelve months from the date of approval of half-yearly and interim financial statements that give a true and fair view.

*Question 4: Do you agree that the directors should disclose when the period they have considered is less than twelve months from the date of approval of half-yearly and interim financial statements that give a true and fair view?*

#### **Implementation date**

Barring unforeseen circumstances the FRC hopes to be in a position to issue the revised Guidance for directors by mid-November 2009 and believes that it would be helpful to bring the revised Guidance into force as soon as practicable. Until the revised Guidance comes into force both the 1994 Guidance and the Update continue to be relevant.

*Question 5: Do you believe that it would be appropriate to replace the existing Guidance for directors with this document for periods ending on or after 31 December 2009? If not, what alternative application date would you suggest?*



## **Introduction and overview**

1. The purpose of this Guidance is to bring together the requirements of company law, accounting standards and the Listing Rules relating to going concern and liquidity risk in relation to small, medium and large UK companies. It is designed to provide a framework to assist directors, audit committees and finance teams in determining whether it is appropriate to adopt the going concern basis for preparing financial statements and in making balanced, proportionate and understandable disclosures. Separate guidance has been issued by the Auditing Practices Board to address the work of auditors in relation to annual financial statements and interim (including half-yearly) financial information.
2. Directors of smaller companies are encouraged to focus on the principles contained in this Guidance and to apply them in a manner proportionate to the nature of their businesses.
3. The principles contained in this Guidance should be applied by directors when preparing annual and interim financial statements that are intended to give a true and fair view. Consequently this Guidance should be applied when preparing half-yearly financial statements in accordance with Disclosure and Transparency Rule (DTR) 4.2 but need not be applied in the preparation of interim management statements required by DTR 4.3.

### **Making an assessment**

4. Going concern is a fundamental accounting concept that underlies the preparation of the annual and interim financial statements of all UK companies. Under the Financial Reporting Standard for Smaller Entities (FRSSE), UK Generally Accepted Accounting Principles for medium and large UK companies (UK GAAP) and International Financial Reporting Standards (IFRS) directors are required to satisfy themselves that it is reasonable for them to conclude that it is appropriate to prepare financial statements on a going concern basis. These requirements are not intended to, and do not, guarantee that a company will remain a going concern until the next interim or annual financial statements are issued.
5. Where companies are facing difficult economic conditions and/or are in financial difficulty this will necessitate particularly careful consideration by directors when making their assessment. If the directors consider that the company might no longer be a going concern they may need to take legal advice.

### **The review process**

6. Smaller UK companies benefit from certain concessions in relation to the accounting standards to be applied and to the content of their financial statements filed at Companies House. However, directors of smaller companies are not relieved from the obligation to assess going concern when they prepare financial statements that give a true and fair view. The extent of the procedures necessary to make an assessment for a smaller company will generally be less than would be appropriate in relation to larger more complex companies.

7. A going concern assessment involves consideration of the facts and circumstances of an individual company. The fact that a business or a subsidiary of a parent company may have no realistic alternative but to cease trading does not of itself mean that a parent company should produce its financial statements on other than a going concern basis. However, such circumstances are likely to trigger specific provisions of the FRSSE, UK GAAP and IFRS, such as a requirement to perform impairment reviews, and are likely to require additional disclosures that are necessary in order for the financial statements to give a true and fair view.
8. Difficult economic conditions present challenges for all of the parties involved in the preparation of annual reports and financial statements. In particular:
  - directors need to ensure that they prepare thoroughly for their assessment of going concern and make appropriate disclosures;
  - auditors need to ensure that they fully consider going concern assessments and refer to going concern in their auditor's reports only when appropriate; and
  - investors and lenders need to be prepared to read and evaluate all of the relevant information in annual reports and financial statements before reacting.
9. Directors should plan their assessment of going concern as early as practicable including deciding on the information and analysis that will need to be produced such as board papers and the processes and procedures that will be undertaken. These plans should also address the evidence to be obtained, including identifying any potential remedial action plan that may need to be addressed, to support their conclusion prior to their approval of the annual or interim financial statements. Addressing these challenges well before the preparation of annual and interim financial statements may mitigate problems arising at the last minute that might unsettle investors and lenders unnecessarily.
10. Early discussions with the company's auditor about these plans may help minimise the risk of last-minute surprises, and it may be helpful for a draft of the relevant disclosures about going concern and liquidity risk to be prepared and discussed with the auditor well before the end of a financial year or interim period.
11. Directors need to evaluate which one of three potential conclusions is appropriate to the specific circumstances of the company. The directors may conclude:
  - there are no material uncertainties that lead to significant doubt about the company's ability to continue as a going concern;
  - there are material uncertainties that lead to significant doubt about the company's ability to continue as a going concern but the going concern basis remains appropriate; or
  - the use of the going concern basis is not appropriate.
12. Care should be taken by the directors to evaluate fully all of the facts and circumstances and to make a balanced assessment of the disclosures that are consequentially necessary. For example, lenders may be reluctant to provide positive confirmation to the directors that facilities will continue to be available. This reluctance may extend to companies with a profitable business and

relatively small borrowing requirements. There may be a number of understandable reasons why a lender may be reluctant to confirm that a facility will be available in the future including:

- the lender responding that as a matter of policy it does not provide such confirmations to its customers during difficult economic conditions;
- the company and its lenders are engaged in negotiations about the terms of a facility (e.g. the interest rate), however there is no evidence that the lender is reluctant to lend to the company; and
- the lender renewed a rolling facility immediately prior to the date of the issuance of the financial statements and is reluctant to go through the administrative burden to confirm the facility will be renewed again in a year's time.

13. However, the absence of confirmations does not of itself necessarily cast significant doubt upon the ability of the company to continue as a going concern nor require auditors necessarily to refer to going concern in their auditor's reports.
14. Difficult market conditions impact companies differently. It should not be assumed that difficult market conditions affecting many companies, of itself, means that a material uncertainty exists about a specific company's ability to continue as a going concern. Similarly, material uncertainties may exist about a company's ability to continue as a going concern in times of relatively benign economic circumstances. Whatever the economic circumstances it is important that a formal and rigorous assessment is made and that financial statements contain balanced, proportionate and understandable disclosures of liquidity risk and going concern uncertainties such as are necessary in order to give a true and fair view.

### **The review period**

15. The FRSSE, UK GAAP and IFRS specify no maximum period that should be considered by directors as part of the assessment of going concern. The extent of the review period is a matter of judgment based on facts and circumstances. However, the FRSSE and UK GAAP provide that disclosure should be made where the review period considered by the directors is less than one year from the date of approval of annual financial statements. Directors of companies applying this Guidance when preparing IFRS financial statements should also make this disclosure in respect of annual and interim financial statements.
16. The practical effect of these disclosure requirements is likely to be that directors of UK companies will adopt a review period of not less than twelve months from the date of approval of annual and interim financial statements intended to give a true and fair view, or in rare cases explain why they have not.

### **Disclosures**

17. The FRSSE, UK GAAP and IFRS require explicit disclosure of the uncertainties that directors are aware of arising from their assessment of going concern that may cast significant doubt on the group's or the company's ability to continue as a going concern. An unqualified going concern conclusion is presumed unless specific reference is made.

18. Listed companies are required by Listing Rule 9.8.6R (3) to make an explicit statement that the business is a going concern, together with supporting assumptions or qualifications as necessary, that has been prepared in accordance with this Guidance<sup>1</sup>.

19. Auditors are required to make their own assessment of the directors' conclusion on going concern. If auditors conclude that a material uncertainty exists which leads to significant doubt about the ability of the entity to continue as a going concern they are required to modify their report by including an emphasis of matter paragraph even if fully explained in the financial statements.

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<sup>1</sup> Text that is shown in blue shading sets out relevant requirements of the Listing Rules. These requirements are applicable only to listed companies.

### Summary of effect of the different conclusions

20. The combination of the facts and circumstances at the date of approval of the financial statements will generally result in one of the following three conclusions that lead to specific disclosures:

Conclusion	Resulting disclosures	Consequence for the auditor's report
<p>No material uncertainties leading to significant doubt about going concern have been identified by the directors.</p>	<p>Going concern is presumed in preparing financial statements. However, disclosure may need to be made about liquidity risk and other matters necessary to give a true and fair view.</p> <p><i>Examples 1 and 2 in Appendix I illustrate this conclusion. Examples 4 and 5 in Appendix I illustrate this conclusion for smaller companies.</i></p> <p><b>For listed companies the Listing Rules require that a statement be made that the business is a going concern.</b></p>	<p>Unmodified report – provided the auditor concurs with the directors' assessment and supporting disclosures.</p>
<p>Material uncertainties leading to significant doubt about going concern have been identified by the directors, but the going concern basis remains appropriate.</p>	<p>Disclosures explaining the specific nature of the material uncertainties that give rise to significant doubt and explaining why the going concern basis has still been adopted.</p> <p><i>Example 3 in Appendix I illustrates this conclusion.</i></p> <p><b>For listed companies the Listing Rules require that a statement be made that the business is a going concern together with supporting assumptions or qualifications as necessary.</b></p>	<p>Modified report including an emphasis of matter paragraph highlighting the existence of material uncertainties – provided the auditor concurs with the directors' assessment and supporting disclosures.</p>
<p>The going concern basis is not appropriate.</p>	<p>Disclosures explaining the basis of the conclusion and the accounting policies applied in drawing up financial statements on a non-going concern basis.</p>	<p>Unmodified report – provided that the financial statements contain the necessary disclosures and the auditor considers the basis to be appropriate to the specific facts and circumstances.</p>

## One – Making an assessment

**Principle 1: Directors should make a formal and rigorous assessment of whether the company is a going concern when preparing financial statements intended to give a true and fair view.**

21. Going concern is a fundamental accounting concept that underlies the preparation of financial statements of all UK companies whether small, medium or large. Under the going concern concept it is assumed that a company will continue in operation and that there is neither the intention, nor the need to, liquidate it or to cease trading or no realistic alternative but to do so.
22. The Companies Act 2006 (CA 2006) specifies certain accounting principles that should be adopted in preparing the financial statements of a company. One of these principles is that:

“the company shall be presumed to be carrying on business as a going concern” (see paragraph 11 of Part 2 to Schedule 1 of both “The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008 No. 410)” and “The Small Companies and Groups (Accounts and Directors’ Report) Regulations 2008 (SI 2008 No. 409)”).

23. Each of the FRSSE, UK GAAP and IFRS require directors to make a going concern assessment. If the directors conclude that a company has no realistic alternative but to cease trading, or go into liquidation, the use of the going concern basis of accounting ceases to be appropriate and this is likely to lead to significant differences in the amounts recognised in the financial statements for its assets and liabilities. For example, for UK companies that have adopted IFRS, IAS 1 “Presentation of Financial Statements” states:

“When preparing financial statements, management shall make an assessment of an entity’s ability to continue as a going concern. An entity shall prepare financial statements on a going concern basis unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so. ...”

24. The assessment of going concern is made at the date that the directors approve the annual report and financial statements, or any interim financial statements, and takes into account the relevant facts and circumstances at that date. As a consequence, it is not possible to give any certainty on going concern. Any judgment made, whilst reasonable at the time, can be valid only at that time and can be overturned by subsequent events.
25. Directors of subsidiary companies of a group need to make their own assessment of the going concern basis of accounting and will take into account the specific facts and circumstances of the subsidiary company and any need for financial support from the parent company or fellow subsidiaries.

## Two – The review process

**Principle 2: The procedures carried out by the directors should be proportionate in nature and depth depending upon the degree to which going concern is an issue for the company and the size and complexity of the company and its operations.**

26. The extent of the review process will depend upon the nature of the company and the complexity of its business. Smaller companies tend to be dependent upon a single provider of finance and have only one business activity with the result that the extent of the process and procedures for a smaller company may be limited. However, it is important that the assessment is carried out and documented.
27. Directors of subsidiary companies may need to obtain information about the financial position of the group as a whole in circumstances where they are dependent upon the availability of such financial support. Practical difficulties may be minimised if the accounts of subsidiary companies are completed and approved close to the date of approval of any group financial statements.
28. Directors are best placed to assess which factors are likely to be of greater significance in relation to their company. These factors will vary by industry and from company to company within a particular industry. For example, one company may have significant economic dependence on a particular customer, whilst another company may have a large number of customers.

### Forecasts and budgets

29. Forecasting and budgeting are long-established techniques in management accounting. When the critical assumptions underlying the forecasts and budgets are challenged and subjected to sensitivity analysis, the refined forecasts and budgets have an increased likelihood of better predicting the outcome.
30. Directors of companies applying the FRSSE, UK GAAP or IFRS (and complying with this Guidance) should prepare a budget, trading estimate, cash flow forecast or similar analysis covering the period up to twelve months from the date of approval of their annual financial statements and any half-yearly and interim financial statements intended to give a true and fair view, or for a longer period.

### Procedures more relevant to medium and large companies

31. Directors of medium and large companies generally assess further periods by way of medium or long-term plans that give an indication in general terms of how the directors expect the business of the company to fare.
32. The following paragraphs describe procedures that are more relevant to the consideration of whether the adoption of the going concern basis of accounting is appropriate for a medium and large company. Directors may determine that certain of the procedures do not apply to their

company. Nevertheless, they should consider whether these matters could become significant for their company during the review period. Appendix II identifies key questions for boards which they may need to consider when carrying out their role in relation to annual and half-yearly financial statements.

### **Products, services and markets**

33. Directors should obtain information about the major aspects of the economic environment within which the company operates. They should consider the size of the market, its strength, their market share and assess whether there are any economic, political or other factors which may cause the market to change. This should be done for each of the main product or service markets.
34. Directors should assess whether their products or services are compatible with their market projections in terms of market position, quality and expected life.

### **Borrowing requirements**

35. The availability of borrowing facilities may be dependent upon the company's compliance with specific terms and conditions (covenants). An analysis of borrowing documentation should be undertaken to ensure that all critical terms and conditions are identified so that the risks to continued compliance can be assessed.
36. If there is uncertainty over the contractual arrangements with lenders and other providers of finance, directors should seek confirmation from the lenders of the principal terms and conditions. However, the absence of confirmations does not of itself necessarily cast significant doubt upon the ability of a company to continue as a going concern.
37. The facilities available to the company should be reviewed and compared to the company's expected cash requirements, as indicated by the cash flow forecasts, budgets or trading estimates, as a minimum for the period ending twelve months from the date of approval of the financial statements.
38. The directors have a responsibility to manage borrowing requirements actively. Any potential deficits, arrears or contractual breaches should be discussed with the company's bankers in order to determine what action is needed. This may prevent potential problems crystallising. The onus is on the directors to be satisfied that there are likely to be appropriate and committed financing arrangements in place.

### **Liability management**

39. Directors should ensure that the financial plans indicate adequate matching of projected cash inflows with known cash outflows. The outflows should include all known liabilities, such as loan repayments, payment of tax liabilities and other commitments, regardless of whether or not they are recognised as liabilities on the balance sheet.

### **Contingent liabilities**

40. Directors should consider the company's exposure to contingent liabilities. These should include potential sources of liability such as legal proceedings, guarantees, environmental costs and product liability.

### **Financial and operational risk management**

41. There are many types of financial and operational risks facing a company and directors should identify which risks are most significant to their company. For example, exposure to fixed-price contracts and to movements in foreign currency exchange rates may be the most significant risks for a construction company engaged in overseas markets. Further, consideration should be given to counterparty risks that arise from concentration on key suppliers or customers who may themselves be facing financial difficulty. The directors should consider how such risks could affect the company and how they are managed in practice.

### **Sensitivity analysis and stress testing**

42. Sensitivity analysis should be prepared to enable an understanding to be gained of the critical assumptions that underlie the budgets and forecasts. Sensitivity analysis involves assessing the extent to which the going concern status of the company varies with changes in assumptions. For example the following may be appropriate to test depending upon the facts and circumstances:
- interest rates;
  - exchange rates;
  - market share;
  - raw material costs;
  - expected selling costs;
  - counterparty default rates;
  - availability of borrowing requirements;
  - likely extent of damages arising from unfavourable legal judgments; and
  - taxation rates.
43. With respect to a company's cash flow requirements, sensitivity analysis should be used to seek to ensure that there are no expected:
- shortfalls in facilities against requirements; or
  - arrears of interest; or
  - breaches of covenants.
44. Where sensitivity analysis indicates that there is a significant risk that the headroom between cash requirements and facilities available will be insufficient, the company should stress test its assumptions. Stress testing enables the directors to assess the effect of a combination of pessimistic but plausible estimates or assumptions.

### **Interim financial statements**

45. UK companies that have adopted IFRS may produce condensed interim financial statements in accordance with IAS 34 “Interim Financial Reporting” that are intended to provide an update on the latest set of annual financial statements. Paragraph 41 of IAS 34 requires that the measurement procedures to be followed in preparing interim financial statements be designed to ensure that the resulting information is reliable but acknowledges that the preparation of interim financial statements generally will require a greater use of estimation methods than annual financial statements.
46. Directors will need to exercise judgment about the nature and extent of the procedures that they apply to assess the use of the going concern assumption at an interim date and the need for disclosures about new activities, events and circumstances. Issues which might trigger a need to re-examine the going concern assumption and going concern and liquidity risk disclosures include:
  - a significant adverse variation in operating cash flows between prior budgets and forecasts and the outturn in the first half of the year;
  - a significant reduction in revenues or margins forecast for the second half of the financial year;
  - a failure to obtain renewal or extension of bank facilities that had been anticipated; or
  - a failure to sell capital assets for their expected amounts or within previously forecast timeframes.
47. If going concern has become a significant issue since the last annual financial statements, directors should undertake procedures similar to those that they would have carried out for annual financial statements to ensure that all relevant issues have been identified and considered.
48. Where no new issues have been identified that raise questions about the assessment made at the last annual financial statements it is likely that the directors will undertake procedures to roll forward the previous budgets and forecasts by the length of the interim period to ensure that no new issues have been missed.

### Three – The review period

**Principle 3: Directors should consider all information about the future that they are aware of when concluding whether the company is a going concern at the date of approval of the financial statements.**

**Directors should disclose if the period that they have reviewed is less than one year from the date of approval of annual, half yearly and interim financial statements that give a true and fair view.**

#### **Annual financial statements**

49. The FRSSE, UK GAAP and IFRS specify no maximum period that should be reviewed by directors as part of the assessment of going concern. The extent of the review period is a matter of judgment based on facts and circumstances. However, the FRSSE and UK GAAP provide that disclosure should be made where the review period considered by the directors is less than one year from the date of approval of the financial statements.
50. For companies applying IFRS the requirements of accounting standards are more specific. Paragraph 26 of IAS 1 provides that “management takes into account all available information about the future, which is at least, but not limited to, twelve months from the end of the reporting period”. However, under this Guidance directors should disclose if the period of the review is shorter than twelve months from the date of approval and explain their decision.

#### **Auditor’s report**

51. If the period of the directors’ review is less than one year from the date of approval of the financial statements and the directors have not disclosed that fact, the auditor is required to do so in the auditor’s report.

#### **Interim financial statements**

52. There is no separate guidance for smaller companies on interim financial statements. This is because it is rare for smaller companies to prepare interim financial statements in accordance with either the FRSSE or UK GAAP. Interim financial statements that are intended to give a true and fair view are also rare for non-listed medium and large companies.
53. The Accounting Standards Board (ASB) has issued a non-mandatory statement “Half-Yearly Financial Reports” for companies complying with UK GAAP. The statement provides that the accounting policies and presentation should be consistent with those applied in the latest published annual financial statements unless (a) the policies and presentation are to be changed in the subsequent annual financial statements or (b) the FSA otherwise agrees.

54. Companies subject to the DTR are required to produce a half yearly financial report in which the financial statements must give a true and fair view. Where such companies use IFRS they are required to apply IAS 34. It provides that the same recognition and measurement principles be applied to interim condensed financial statements as are applied to a full set of either interim or annual financial statements. Consequently, the review period requirement in paragraph 26 of IAS 1 applies to all financial statements produced in accordance with IFRS irrespective of whether they are a complete set of financial statements as described in IAS 1 or a condensed set of financial statements for an interim period as described in IAS 34<sup>2</sup>. Where such companies use UK GAAP, the DTR refers to the ASB's statement described in paragraph 53.
55. Where the period considered by the directors in assessing going concern for an interim period in accordance with accounting standards has been limited to a period of less than twelve months from the date of the approval of half-yearly and interim financial statements intended to give a true and fair view, directors complying with this Guidance should disclose that fact and explain their decision.

**All financial statements intended to give a true and fair view**

56. The practical effect of these disclosure requirements is likely to be that directors of all UK companies will adopt a review period of not less than twelve months from the date of approval of annual, half yearly and interim financial statements intended to give a true and fair view, and in rare cases explain why they have not.

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<sup>2</sup> In the Listing Rules "interim accounts" are described as "half-yearly financial reports".

## Four – Disclosures

**Principle 4: Directors should make balanced, proportionate and understandable disclosures about going concern in order to give a true and fair view.**

57. Directors of all companies need to reach a conclusion about the ability of the company to continue as a going concern and the uncertainties that are present. The disclosures which follow from this conclusion will be one of:
- there are no material uncertainties that may cast significant doubt about the ability of the company to continue as a going concern. Directors should use the going concern basis of accounting in preparing the financial statements. However, disclosure may need to be made about liquidity risk and other disclosures may be necessary to give a true and fair view. The extent of these disclosures will depend on the specific facts and circumstances; or
  - there are material uncertainties that may cast significant doubt about the ability of the company to continue as a going concern, but the going concern basis remains appropriate. Directors should use the going concern basis of accounting in preparing the financial statements and disclose the material uncertainties that give rise to significant doubt; or
  - there is no realistic alternative to liquidation. Such a conclusion will result in abandoning the going concern basis of accounting in preparing the financial statements and making detailed disclosures about the basis of accounting that has been used.
58. The FRSSE does not specify the nature of the disclosure requirements that should be made where directors of a smaller company identify a material uncertainty that leads to significant doubt about going concern. However, the disclosure should set out the facts and circumstances in a manner that is proportional to the nature of the company. Directors of smaller companies will also need to consider whether other uncertainties need to be disclosed in order for the financial statements to give a true and fair view.

### **Directors' Reports of medium and large companies**

59. CA 2006 requires the Directors' Report of medium and large companies to include a Business Review.
60. The Business Review is required to be a balanced and comprehensive analysis of the development and performance of the company's business during the financial year and the position of the company at the end of that year, consistent with the size and complexity of the business. In particular it must include a description of the principal risks and uncertainties facing the company.
61. In the case of a quoted company, the Business Review is also required to provide information on a number of other matters including:
- the main trends and factors likely to affect the future development, performance or position of the company's business; and

- information about persons with whom the company has contractual or other arrangements that are essential to the business of the company.

62. Directors need to explain in the Business Review the principal risks and uncertainties facing the company which should include any particular economic conditions and financial difficulties that the company is experiencing. One of the purposes of the Business Review is to help the members assess how the directors have performed their duties, so it is reasonable to expect that it will also contain an account of how the directors intend to respond to these risks and uncertainties. Issues which may require disclosure depend upon individual facts and circumstances and may include:

- uncertainties about current financing arrangements (whether committed or uncommitted);
- potential changes in financing arrangements such as critical covenants and any need to increase borrowing levels;
- counterparty risks arising from current credit arrangements (including the availability of insurance where relevant) with either customers or suppliers;
- a dependency on key suppliers and/or customers; and
- uncertainties posed by the potential impact of the economic outlook on business activities.

63. CA 2006 requires the auditor to review the Directors' Report and to state in their report whether the information given in the Directors' Report is consistent with the financial statements.

#### **Disclosure requirements about going concern and liquidity risk**

64. The FRSSE, FRS 18 "Accounting policies" and IAS 1 all require directors to disclose the existence and nature of the uncertainties where they have concluded that there are "material uncertainties that may cast significant doubt upon the entity's ability to continue as a going concern".

65. The FRSSE, FRS 18 and IAS 1 do not specify that this precise phrase must be used. However, when preparing their financial statements directors will wish to bear in mind the need for the disclosures to be clear about them having identified a material uncertainty that has led to significant doubt about going concern. They will also wish to bear in mind the obligation on the auditor to report if that level of clarity has not been achieved in the words that have been used, and made clear that the company may be unable to realise its assets and discharge its liabilities in the normal course of business.

66. In addition, for medium and large companies a number of UK GAAP and IFRS standards require specific disclosures to be made about liquidity risk and other risks that may have a bearing on a going concern assessment including:

Disclosure	IFRS Reference (2008)	UK GAAP (2007/8)
Disclosures relating to risks arising from financial instruments, including liquidity risk where it is material.	IFRS 7 paragraphs 31 to 42	FRS 29 paragraphs 31 to 42
Disclosure is encouraged of undrawn borrowing facilities and any restrictions such as covenant requirements, where relevant.	IAS 7 paragraph 50 (a)	No explicit requirement or encouragement
Disclosure of defaults and covenant breaches and potential reclassification of loans in default as current liabilities.	IAS 1 paragraphs 74 to 76	FRS 25 paragraphs 50C to 50E
Disclosure of key sources of estimation uncertainty about the carrying amounts of assets and liabilities.	IAS 1 paragraphs 125 to 133	FRS 18 paragraphs 50 to 55

### Liquidity risk

67. Liquidity risk is the risk that an entity will encounter difficulty in meeting its obligations associated with financial liabilities. FRS 29 “Financial Instruments: Disclosures” and IFRS 7 “Financial Instruments: Disclosures” require a company to make both qualitative and quantitative disclosures concerning liquidity risk, where it is a material financial risk.
68. Where liquidity risk is material, FRS 29 and IFRS 7 require:
- disclosure of information that enables users to evaluate the nature and extent of the entity’s exposure to liquidity risk;
  - narrative disclosures explaining how liquidity risk arises in the business and how it is managed in practice;
  - summary numerical data about liquidity risk based on the information that is provided to key management personnel, often the Board of Directors; and
  - certain mandatory disclosures such as a maturity analysis of financial liabilities.
69. For companies using IFRS, the disclosures required by IFRS 7 are supplemented by disclosures required by other IFRS standards. For example, IAS 7 “Statement of cash flows” requires disclosure of undrawn borrowing facilities where relevant to users’ understanding of the financial position and liquidity of the entity, whilst IAS 1 requires disclosure of defaults and breaches of loan terms and conditions.

## Additional disclosure requirements of listed companies

70. Listing Rule 9.8.6R (3) of the Financial Services Authority requires that the following must be included in the annual financial reports of listed companies incorporated in the United Kingdom:

“...a statement made by the directors that the business is a going concern, together with supporting assumptions or qualifications as necessary, that has been prepared in accordance with *Going Concern and Financial Reporting: Guidance for Directors of listed companies registered in the United Kingdom*, published in [November 1994]”

71. Preliminary announcements of annual results form one of the focal points for investor interest, primarily because they confirm or update market expectations.

72. Under the Listing Rules such announcements are voluntary, although if made their contents are subject to minimum requirements. One such requirement (Listing Rule 9.7A.1(2)) is “If a listed company prepares a preliminary statement of annual results the statement must be agreed with the company’s auditor prior to publication”.

73. Directors may need to consider whether, in light of the requirement “to include any significant additional information necessary for the purpose of assessing the results being announced” (Listing Rule 9.7A.1(5)) they need to make appropriate disclosures about going concern in their preliminary announcements.

74. Listing Rule 9.8.10R (1) requires the auditor to review the directors’ statement before the annual report is published. The Listing Rules also require specific disclosure in the preliminary announcement of the nature of any likely modification contained in the auditor’s report that is to be included with the annual financial report.

75. Modified auditor’s reports encompass auditor’s reports that:

- are qualified;
- express an adverse opinion;
- express a disclaimer of opinion; or
- contain an emphasis of matter paragraph (including a paragraph highlighting a material matter regarding a going concern problem).

### Balanced, proportionate and understandable disclosures

76. Addressing the diverse requirements of CA 2006, FRSSE, UK GAAP, IFRS and the Listing Rules that apply to a company may lead it to address going concern and liquidity risk disclosures in a disjointed manner in different sections of its annual report and financial statements. This may create difficulties for investors and other stakeholders in seeking to obtain a clear, comprehensive and cohesive understanding of the issues facing the company.

77. Where practical, it is helpful to investors and other stakeholders if all of these disclosures are brought together in a single note to the company's financial statements. It may be necessary to provide a cross reference to this note from other parts of the annual report. If it is not practical to provide all of the information in such a note, it is still helpful if the key disclosures are brought together by way of a note that includes appropriate cross references to information in the financial statements and from the financial statements to information included elsewhere in the annual report.
78. Such a note would include the following components:
- the key disclosures, or references thereto, as discussed in the above paragraph;
  - the particular factors which the directors have considered in reaching a conclusion on going concern; and
  - a concluding statement as to whether the use of the going concern basis of accounting is appropriate, explaining the basis of that conclusion.
79. Clutter caused by excessive disclosure of irrelevant or immaterial information and data has the capacity to detract from the ability of users of financial statements to identify the relative significance of issues facing a company and in an extreme could undermine the ability of financial statements to provide a true and fair view. The extent and detail of disclosures about uncertainties related to going concern should reflect the facts and circumstances present at the date of approval of the financial statements.
80. Examples illustrating such disclosures and how they can be brought together are included in Appendix I to this Guidance.

### **Auditor's report**

81. Auditors are required to evaluate the directors' assessment of the company's ability to continue as a going concern. If auditors conclude that a material uncertainty exists which leads to significant doubt about the ability of the entity to continue as a going concern they are required to modify their report by including an emphasis of matter paragraph even if the circumstances are fully explained in the financial statements.
82. Auditors are also required to consider the disclosures about going concern and liquidity risk made in the financial statements. In relation to audited financial statements, if auditors conclude that the disclosures are not adequate to meet the requirements of accounting standards or CA 2006, including the need for financial statements to give a true and fair view, they are required to qualify their opinion and to provide their reasons for doing so.

### **Condensed financial statements for an interim period (half-yearly financial statements for listed companies)**

83. IAS 34 provides that entities may elect to provide less information at interim dates as compared with their annual financial statements in the interests of timeliness and cost considerations and to avoid repetition of information previously reported. Instead the focus of interim condensed financial statements is on new activities, events and circumstances and does not duplicate previously reported information.
84. Directors will need to exercise judgment in determining the disclosures about going concern and liquidity risk that they should include in a set of interim condensed financial statements. Practical experience suggests that new events and circumstances are likely to arise quite often in businesses facing financial difficulties, for example as borrowings are renegotiated and assets and businesses are sold or closed. In these circumstances it is likely that interim condensed financial statements will include additional explanation about going concern and liquidity risk. In other cases a short statement confirming the use of the going concern basis should suffice.

### **Auditor interim review reports**

85. Auditors may be engaged to review half-yearly financial statements. The APB's International Standard on Review Engagements (UK and Ireland) 2410 "Review of interim financial information performed by the independent auditor of the entity" requires auditors, among other things, to inquire whether the directors have changed their assessment of the entity's ability to continue as a going concern.
86. When the auditor becomes aware of events or conditions that may cast significant doubt on the company's ability to continue as a going concern, the auditor is required to inquire of the directors as to their plans for future actions, the feasibility of those plans and whether the directors believe that the outcome of those plans will improve the situation. The auditor is also required to consider the adequacy of the disclosure about such matters in the half yearly financial statements.

## **Appendix I – Examples of going concern disclosures**

The purpose of this Appendix is merely to illustrate the guidance in paragraphs 76 to 79 in bringing together going concern and liquidity risk disclosures. In practice such disclosures should be specific to the individual circumstances of each company.

### **Example 1 – A group with a significant positive bank balance, uncomplicated circumstances and little or no exposure to economic difficulties that may impact the going concern assumption.**

The group's business activities, together with the factors likely to affect its future development, performance and position are set out in the Business Review on pages X to Y. The financial position of the group, its cash flows, liquidity position and borrowing facilities are described in the Chief Financial Officer's Review on pages P to Q. In addition note A to the financial statements includes the group's objectives, policies and processes for managing its capital; its financial risk management objectives; details of its financial instruments and hedging activities; and its exposures to credit risk and liquidity risk.

The group has considerable financial resources together with long-term contracts with a number of customers and suppliers across different geographic areas and industries. As a consequence, the directors believe that the group is well placed to manage its business risks successfully despite the current uncertain economic outlook.

After making enquiries, the directors have a reasonable expectation that the company and the group have adequate resources to continue in operational existence for the foreseeable future. Accordingly, they continue to adopt the going concern basis in preparing the annual report and financial statements.

### **Example 2 – A group with uncomplicated circumstances, some exposure to economic difficulties and either a current material bank overdraft or loan and a need to renew this facility in the foreseeable future albeit not imminently.**

The group's business activities, together with the factors likely to affect its future development, performance and position are set out in the Business Review on pages X to Y. The financial position of the group, its cash flows, liquidity position and borrowing facilities are described in the Chief Financial Officer's Review on pages P to Q. In addition note A to the financial statements includes the group's objectives, policies and processes for managing its capital; its financial risk management objectives; details of its financial instruments and hedging activities; and its exposures to credit risk and liquidity risk.

As highlighted in note B to the financial statements, the group meets its day-to-day working capital requirements through an overdraft facility that is due for renewal on [date]. The current economic conditions create uncertainty particularly over (a) the level of demand for the group's products; (b) the exchange rate between sterling and currency X and thus the consequence for the cost of the group's raw materials; and (c) the availability of bank finance in the foreseeable future.

The group's forecasts and projections, taking account of reasonably possible changes in trading performance, show that the group should be able to operate within the level of its current facility. The group will open renewal negotiations with the bank in due course and has at this stage not sought any written commitment that the facility will be renewed. However, the group has held discussion with its bankers about its future borrowing needs and no matters have been drawn to its attention to suggest that renewal may not be forthcoming on acceptable terms.

After making enquiries, the directors have a reasonable expectation that the company and the group have adequate resources to continue in operational existence for the foreseeable future. Accordingly, they continue to adopt the going concern basis in preparing the annual report and financial statements.

**Example 3 – A group with complicated circumstances, considerable exposure to economic difficulties and either a current material bank overdraft or loan that requires renewal and perhaps an increase in the year ahead.**

The group's business activities, together with the factors likely to affect its future development, performance and position are set out in the Business Review on pages X to Y. The financial position of the group, its cash flows, liquidity position and borrowing facilities are described in the Chief Financial Officer's Review on pages P to Q. In addition note A to the financial statements includes the group's objectives, policies and processes for managing its capital; its financial risk management objectives; details of its financial instruments and hedging activities; and its exposures to credit risk and liquidity risk.

As described in the directors' report on page X the current economic environment is challenging and the group has reported an operating loss for the year. The directors' consider that the outlook presents significant challenges in terms of sales volume and pricing as well as input costs. Whilst the directors have instituted measures to preserve cash and secure additional finance, these circumstances create material uncertainties over future trading results and cash flows.

As explained on page X, the directors are seeking to sell a property to provide additional working capital. The group is in negotiations with a potential purchaser but there can be no certainty that a sale will proceed. Based on negotiations conducted to date the directors have a reasonable expectation that it will proceed successfully, but if not the group will need to secure additional finance facilities.

As explained in the Business Review on page Y, the group has commenced discussions with its bankers about an additional facility that may prove to be necessary should the sale of the property not proceed or should material adverse changes in sales volumes or margins occur. It is likely that these discussions will not be completed for some time. The directors are also pursuing alternative sources of funding in case an additional facility is not forthcoming, but have not yet secured a commitment.

The directors have concluded that the combination of these circumstances represent a material uncertainty that casts significant doubt upon the group's and the company's ability to continue as a going concern. Nevertheless after making enquiries, and considering the uncertainties described above,

the directors have a reasonable expectation that the group and the company have adequate resources to continue in operational existence for the foreseeable future. For these reasons, they continue to adopt the going concern basis in preparing the annual report and financial statements.

**Example 4 – A smaller company that has adopted the FRSSE and anticipates reduced turnover next year.**

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.

**Example 5 – A smaller company that has adopted the FRSSE and anticipates renewing a major contract in the near future.**

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.

## Appendix II – Key questions for boards

For large and medium-sized companies this Appendix provides questions that the board may wish to consider and discuss with management when determining the appropriateness of adopting the going concern basis of accounting.

The questions are not intended to be exhaustive and neither will all questions be appropriate for every company. This Appendix should be read in conjunction with the procedures described in Section Two<sup>3</sup>.

### 1. FORECASTS AND BUDGETS

1.1 Has management prepared monthly cash flow forecasts and monthly budgets covering, as a minimum, a period of twelve months from the expected date of approval of the financial statements?

1.2 Has management developed a list of assumptions (including macro-economic assumptions) that underlie the forecasts? Such assumptions might include:

- gross profit margins that are realistic and consistent with past performance, the existing and anticipated pricing structure and order book;
- expected sales mix and yield;
- the patterns of expected debtor collections (including explanation of their relationship to current debtor collections);
- levels of stock holding and work in progress;
- working capital requirements;
- payment terms with creditors;
- capital asset replacement programmes;
- cost escalation as a result of inflation, contractual terms or seasonal fluctuations; and
- overhead levels?

1.3 In determining the appropriateness of the going concern basis has management adequately taken into account:

- expected levels of earnings;
- the stability of the cost base;
- potential labour difficulties;
- the risk of losing key staff;
- the risk of losing a key patent or franchise;
- potential losses on long-term contracts; and
- adequacy of the company's insurance policies?

1.4 Have the forecasts been tested by performing sensitivity analyses on the critical assumptions, particularly in relation to differing levels of activity?

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<sup>3</sup> Section 2 of "Going Concern and Liquidity Risk: Guidance for Directors of UK Companies published by the Financial Reporting Council"

1.5 Have lessons learnt from inaccurate forecasting in the past been appropriately reflected in the forecasts?

## **2. BORROWING REQUIREMENTS**

2.1 Are the covenants on current borrowings satisfied as at the balance sheet date?

2.2 Are there any arrears of interest on current borrowings as at the balance sheet date?

2.3 Have the monthly forecast cash flow positions been compared to facilities available to establish whether or not there are any projected deficits. If there are projected deficits are there plans in place to cover them, for example to renegotiate facilities with the company's bankers?

2.4 Have the forecasts been tested against existing covenants to assess whether any breaches should be anticipated? If so, are there plans in place to prevent the breaches occurring?

## **3 LIABILITY MANAGEMENT**

3.1. Has management analysed all known liabilities, commitments and repayment dates in the future, including the period beyond twelve months from the expected date of approval of the financial statements?

3.2 Where there are projected outflows that are unmatched by inflows, has management considered how the funds will be raised and whether appropriate arrangements can be put in place to meet payments as they fall due?

## **4. CONTINGENT LIABILITIES**

4.1 Has management considered the exposure of the company to contingent liabilities, for example, those arising through:

- legal proceedings;
- guarantees and/or warranties;
- product liability not covered by insurance;
- grants received that are subject to conditions;
- environmental clean-up costs;
- decommissioning costs;
- intra-group guarantees; and
- retentions?

## **5. PRODUCTS, SERVICES AND MARKETS**

5.1 For each of the main products or services, has management considered the relative strength of the company's products within the market and considered whether there are any economic, political or other factors that may cause the market, or the strength of the company's products within the market, to change?

5.2 Has management considered whether their marketing strategy is likely to secure future market shares as projected in forecasts?

5.3 Has management considered the mix of customers and whether the company's turnover is economically dependent on too small a number? Has management evaluated counter party risks such as the risk of losing these customers, for example by reviewing the customers themselves, their activities and whether these are changing? If there is a high risk of losing existing customers has management considered the likelihood of finding alternative sales markets?

## **6. FINANCIAL AND OPERATIONAL RISK MANAGEMENT**

6.1 Has management's stress testing evaluated the risk to the company of:

- adverse movements in interest rates;
- adverse movements in currency exchange rates; and
- exposure to risk through major fixed-price or fixed-rate contracts?

## **7. FINANCIAL ADAPTABILITY**

7.1 Has management developed an adequate plan to enable it to take effective action to alter the amounts and timing of its cash flows so that it can respond to unexpected needs or opportunities?

7.2 In determining the financial adaptability of the company has management considered the ability of the company to:

- dispose of assets or to postpone the replacement of assets without significantly affecting cash flows;
- lease assets rather than to purchase outright;
- obtain new sources of finance;
- renew or extend loans;
- restructure debts;
- raise additional share capital;
- obtain financial support from other group companies; and
- continue business by making limited reductions in the level of operations or by making use of alternative resources?

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**FINANCIAL REPORTING COUNCIL**  
**5TH FLOOR**  
**ALDWYCH HOUSE**  
**71-91 ALDWYCH**  
**LONDON WC2B 4HN**  
**TEL: +44 (0)20 7492 2300**  
**FAX: +44 (0)20 7492 2301**  
**WEBSITE: [www.frc.org.uk](http://www.frc.org.uk)**