



**FINANCIAL REPORTING COUNCIL**

**GOING CONCERN AND FINANCIAL REPORTING**

**PROPOSALS TO REVISE THE GUIDANCE FOR DIRECTORS OF  
LISTED COMPANIES**

**CONSULTATION PAPER**

**SEPTEMBER 2008**

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

The Consultation Paper asks for responses to a number of specific 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.

Comments, to reach the FRC by **24 November 2008**, should preferably be sent as a word file attachment to an e-mail to: [s.leonard@frc-apb.org.uk](mailto:s.leonard@frc-apb.org.uk)

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All responses will be regarded as being on the public record unless confidentiality is expressly requested, and 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.

## Contents

		<i>Page</i>
<b>One</b>	<b>Background</b>	<b>1</b>
<hr/>		
<b>Two</b>	<b>Consultation questions</b>	<b>4</b>
<hr/>		
<b>Three</b>	<b>Proposed revision of existing guidance</b>	<b>6</b>
<hr/>		
<b>Annex</b>	<b>Developments in International Financial Reporting Standards since 1994 relating to going concern</b>	<b>27</b>
<hr/>		



## One – Background

### The Guidance for Directors on reporting on the going concern status of companies

The Listing Rules of the Financial Services Authority and the Irish Stock Exchange require that the annual reports of listed companies include a statement by the directors that the business is a going concern, together with supporting assumptions or qualifications as necessary. In making this statement, directors are required to consider the guidance contained in “Going Concern and Financial Reporting: Guidance for directors of listed companies registered in the United Kingdom,” (The Guidance for Directors) which was published in November 1994<sup>1</sup>. The Listing Rules further require that the auditor review the directors’ statement before the annual report is published.

The Guidance for Directors was written by a Working Group<sup>2</sup> formed under the auspices of the Cadbury Committee that reported on the Financial Aspects of Corporate Governance. The formation of the Working Group arose out of concerns that there had been several high-profile company failures where there had been no apparent indication of the imminent problems in the previous year’s report and accounts.

The Guidance for Directors did not create new duties for directors. The Exposure Draft of the Guidance for Directors noted “The directors of listed companies, in varying degrees, already follow procedures that are of assistance in establishing that the going-concern basis is appropriate. These draft recommendations are intended to codify best practice for directors in formally considering the appropriateness of the going concern basis for their company’s financial statements”.

The objective of the Guidance for Directors is to support good corporate reporting and, in particular, the requirements of the Listing Rules and Accounting Standards. When a company is not a going concern this does not necessarily mean that it is, or is likely to become, insolvent. The Guidance for Directors is not intended to address aspects of insolvency and, in particular, is not intended to support the requirements of the Insolvency Act 1986.

Since its publication, 14 years ago, the Guidance for Directors has not been the subject of any revision. However, the need for guidance was re-considered in 1998 when the Committee on Corporate Governance noted that “we would not wish to recommend the removal of this requirement and thus to risk downgrading the importance of “going concern”.

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<sup>1</sup> The detailed requirements concerning disclosure by directors are set out in paragraphs 47 to 54 of the Guidance for Directors.

<sup>2</sup> The Working Group comprised members of the Hundred Group of Finance Directors, the Institute of Chartered Accountants in England & Wales and the Institute of Chartered Accountants of Scotland.

During 2006 the Financial Services Authority (the FSA) consulted on whether to retain the requirement as part of its implementation of the Transparency Directive. In its feedback statement the FSA concluded “we intend to retain all of the Listing Rule requirements ... on the basis that each adds benefit to the smooth operation of the UK markets”.

### **Purpose of this Consultation Paper**

The Financial Reporting Council (the FRC) is seeking to determine whether the Guidance for Directors should be revised, and the purpose of this document is to obtain the views of stakeholders.

The Cadbury Code has evolved into the Combined Code. However, the provision related to the directors’ statement remains unchanged. Code Provision C.1.2 of the June 2008 Combined Code states that “The directors should report that the business is a going concern, with supporting assumptions or qualifications as necessary.”

In the period since 1994 there have been substantial changes to the accounting standards applied by directors of listed companies. This is particularly the case for directors preparing consolidated accounts required to comply with International Financial Reporting Standards (IFRSs) as adopted by the EU. The Annex to this consultation document identifies the key requirements of the IFRSs that are relevant to going concern. In particular, the FRC notes that substantial additional disclosures are required about how liquidity risks are managed, the maturity profile of liabilities and details of any defaults on borrowing covenants.

The FRC observes that current economic conditions are creating particular challenges for companies. Recent developments in global debt markets have led banks to be cautious of lending to one another (the so-called “credit crunch”). This has severely restricted liquidity which has created unexpected financial difficulties for banks and entities that depend on the availability of loans as a key source of capital. Many market commentators are now forecasting a period of reduced growth and in some cases recession, with the result that going concern questions are likely to need to be considered in more detail by Boards of Directors.

In view of these deteriorating economic conditions the FRC has concluded that this is an appropriate time to consider whether the existing Guidance for Directors is necessary and remains appropriate, or whether it can be improved.

The FRC believes that the use of the going concern basis of accounting is so fundamental to the preparation of financial statements that directors should make an explicit written statement in their annual report and accounts that they are satisfied that the going concern assumption remains appropriate.

The FRC also believes that directors should disclose in their annual report and accounts when the period they have reviewed in making their assessment of going concern does not extend to at least 12 months from the date of their approval of the financial statements.

The FRC acknowledges that the Guidance for Directors and the requirement of FRS 18 for a disclosure when the period of review is less than 12 months from the date of approval is more onerous than the equivalent requirements contained in IFRSs<sup>3</sup>. However, the FRC believes that the UK and Irish approach is superior to that of the IFRSs, and that IFRSs should be modified to converge with UK and Irish requirements.

The FRC notes that the UK and Irish approach has been widely adopted within Europe, as evidenced by the recommendations of the Committee of European Securities Regulators with respect to working capital statements made in Prospectuses<sup>4</sup>.

In view of the above conclusions, this consultation document has been produced on the assumption that the Guidance for Directors, and in particular the disclosure requirements should continue to exist. However, the FRC acknowledges that developments in IFRSs and markets may mean that the guidance may need to be refreshed. Accordingly, Section 2 of this consultation document contains a proposed updated version of the existing Guidance for Directors.

The approach adopted in the proposal has been to keep amendments to the minimum necessary and to seek views from stakeholders on whether more fundamental changes are necessary.

The FRC complies, where possible, with best practice for consultations and accordingly has set a 12 week comment period ending on 24 November 2008. The FRC believes that it will not be practical to evaluate comments received and amend the Listing Rules to refer to the revised Guidance for Directors before companies are completing their work on December 2008 year-ends. However, the FRC intends to publish a summary of key comments received and its plan for revision during December 2008 to assist Boards of Directors to understand, on a timely basis, how the Guidance for Directors may be amended.

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<sup>3</sup> See IAS 1 paragraph 26.

<sup>4</sup> "CESR's recommendations for the consistent implementation of the European Commission's Regulation on Prospectuses no. 809/2004". (CESR 2005) Paragraphs 108-126.

## Two – Consultation questions

The FRC would welcome receiving the views of stakeholders on the following questions.

### **Need for Guidance for Directors**

The FRC has observed that very significant changes have been made to the accounting standards that must be applied by directors of listed companies when preparing their consolidated accounts in compliance with IFRSs as adopted for use in the EU (see Appendix 1). However, these changes principally address financial statement disclosures rather than guidance on process.

**Question 1: In the light of these developments, do you believe that there is a continuing need for separate Guidance for Directors about Going Concern?**

*The following questions need not be addressed if you respond that you consider that the guidance is no longer necessary.*

### **Adequacy of proposed amendments to the existing guidance**

The FRC has set out some proposed amendments to the existing Guidance for Directors with the objective of a minimal update to respond to changes in the supporting standards and rules (see Section 2). The FRC has not sought to identify substantial additional material that might be included.

**Question 2: Do you believe that the proposed amendments are sufficient and appropriate? If not, what alternative amendments do you believe need to be made and why?**

### **Redundant content in the proposed guidance**

The FRC has not set out to adopt a more radical approach to the proposed Guidance for Directors, such as a bottom up wholesale re-write. As a result, the FRC has not considered whether substantial parts of the text could be dropped (see Section 2).

**Question 3: Do you believe that any significant parts of the proposed guidance can be deleted as unnecessary? If so, which paragraphs can be removed and why?**

### **Approach to the inclusion of example text for directors to include in financial statements**

The FRC notes that since 1994 there has been a trend away from giving detailed guidance that prescribes standardised text towards encouraging directors to draft the text of disclosures in a way that is specific to their own facts and circumstances. However, the proposed guidance continues to contain example disclosures (see Section 2 paragraphs 49 and 51).

**Question 4: Do you believe that it continues to be appropriate to include standardised text within the proposed Guidance for Directors indicating how directors might explain their use of the going concern basis of accounting?**

**Approach to the disclosure of a minimum period of review**

The FRC notes that the proposed text continues to be consistent with International Standards on Auditing (UK and Ireland) which, among other things, require disclosure to be made by the auditor if the period considered by the directors in making their going concern assessment is less than one year from the date of approval of the financial statements. However, whilst IFRSs require management to take into account all available information about the future, this period need only be twelve months from the end of the reporting period.

**Question 5: Do you believe that it continues to be appropriate for the Guidance for Directors to require directors to consider whether an additional disclosure should be given where they have not considered a period that extends to at least twelve months from the date of approval of the financial statements?**

### **Three – Proposed revision of existing guidance**

The existing Guidance for Directors comprises 57 paragraphs. Its principal features are:

- Educational - (by providing in paragraphs 1-23 an explanation of the significance of going concern);
- Guidance - a description of an appropriate process (by describing in paragraphs 24-42 the procedures that directors should undertake in order to make an explicit statement on going concern); and
- Recommended text - by setting out in paragraphs 43 to 54 possible wording of the directors' disclosure under three possible scenarios.

A six page appendix to the guidance sets out examples of detailed procedures which may be appropriate, but these are illustrative rather than prescriptive.

The following pages contain a draft of the existing guidance marked up to show proposed revisions that would bring the guidance up to date.

# GOING CONCERN AND FINANCIAL REPORTING

GUIDANCE FOR DIRECTORS  
OF LISTED COMPANIES  
INCORPORATED~~REGISTERED~~ IN THE UK

~~November 1994~~ 2008

## **FOREWORD**

~~from the Committee on the Financial Aspects of Corporate Governance ('Cadbury Committee')~~

~~The Committee recognises the extent of the task which it set the Working Group on Going Concern in asking it to provide directors of listed companies with the guidance which they needed in order to comply with paragraph 4.6 of the Code of Best Practice. The Committee appreciates the way in which the Working Group has arrived at its conclusions and has drafted them.~~

~~The Committee's aim was to clarify where the responsibilities for the financial aspects of corporate governance lay and to provide a framework for reporting on their discharge. The Working Group's guidance furthers that aim and sets out the governance principles which boards of directors should adopt in the matter of going concern.~~

~~Establishing governance standards and developing them through examples of good practice is a continuing process to which this report has made an important contribution. Although it is addressed in the first instance to listed companies in support of their statements of compliance, the guidance proposed by the Working Group clarifies the concept of going concern to the benefit of businesses of all kinds.~~

# CONTENTS

	<b>Paragraph</b>
Preface	1 – <a href="#">34</a>
Introduction	
Objectives	5 - 6
Scope	<a href="#">7</a> - 8
<del>Accounting concepts</del>	<del>9 – 11</del>
<a href="#">The going concern concept</a>	<a href="#">11 - 15</a>
<del>Definition of going concern</del>	<del>12 – 15</del>
Foreseeable future	<a href="#">17</a> <del>6</del> - 20
Use of going concern basis	21 - 22
Insolvency	23
Procedures	
General	24 - 27
Forecasts and budgets	28 - <a href="#">29</a> <sup>A</sup>
Borrowing requirements	30 - 32
Liability management	33
Contingent liabilities	34
Products and markets	35 - 36
Financial risk management	37
Other factors	38 - 39
Financial adaptability	40
Assessment of factors	41 - 42
Disclosure by directors	
Location of disclosure <a href="#">of going concern statement</a>	43 - 46
Content of disclosure	47
Going concern presumption appropriate	48 - 49
Going concern basis used despite doubts on going concern presumption	50 – <a href="#">51</a> <sup>A</sup>
Going concern basis not appropriate	52 - 54
Other issues	
Application to groups of companies	55
Relevant date for disclosure	56
Interim reporting	57
Appendix	
Detailed procedures	

## PREFACE

1. The Main Principle contained in the Combined Code is that “The board should present a balanced and understandable assessment of the company’s position and prospects.” Code Provision C.1.2 of The Combined Code Committee on the Financial Aspects of Corporate Governance (the ‘Cadbury Committee’) recommends in its Code of Best Practice, dated December 1992, that “The directors should state in their report and accounts that the business is a going concern, with supporting assumptions or qualifications as necessary (paragraph 4.6 of the Code) and that the auditors should report on this statement (paragraph 5.22 of the Report).
2. This recommendation is intended to ensure that directors satisfy themselves explicitly that it is reasonable for them to presume that the company is a going concern in drawing up the financial statements. It is not intended to, and indeed cannot, guarantee that a company will remain a going concern until the next annual report and accounts are issued.
- 2A. 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]”*
- 2B. Listing Rule 9.8.10R (1) requires the auditor to review the directors’ statement before the annual report is published.
3. This document sets out guidance to help directors in complying with the Listing Rules, this recommendation. The Code of Best Practice applies in respect of years ending after 30 June 1993. Note 13 to the Code notes that companies will not be able to comply with paragraph 4.6 until the necessary guidance for companies becomes available. With the publication of this guidance, directors are enabled to make the statement recommended by the Cadbury Committee, and they are encouraged to do so as soon as they are able.
4. ~~An explicit statement on the appropriateness of the going concern presumption in financial statements is a new departure. Consequently, there has been little experience of the practical implications and a consensus as to the details of best practice will emerge as experience is gained. This guidance, therefore and~~ providegive the broad principles which directors should consider in complying with the recommendation of the Combined Code of Best Practice on going concern. An appendix sets out examples of detailed procedures which may be appropriate, but these are illustrative rather than prescriptive.

## INTRODUCTION

### Objectives

5. The purposes of this document are:
  - to explain the significance of going concern in relation to the financial statements;
  - to describe the procedures that making an explicit statement on going concern may entail; and
  - to recommend appropriate disclosure.
6. ~~The directors of listed companies already follow many procedures that are relevant in determining that the going concern presumption is appropriate in drawing up the financial statements. Because these recommendations are~~ As this guidance is intended to codify best practice for directors, it is not expected that there should be any substantial increase in the amount of work that is necessary.

### Scope

7. ~~The Cadbury Report is directed to all listed companies registered in the UK. This includes companies which are registered on the USM. The London Stock Exchange has amended the continuing obligations imposed on companies to require a statement from the directors regarding the extent of their compliance with the Code of Best Practice.~~
8. This guidance is primarily intended for directors of listed companies. However, it ~~This guidance~~ may also be of assistance to all directors in discharging their obligations under the Companies Act ~~2006~~1985 to prepare financial statements using the going concern basis. In particular, the directors of AIM companies, PLUS-quoted companies, large private companies and 'public interest' ~~entities~~ companies may wish to adopt appropriate procedures in order to comply with best practice.

### Accounting concepts

9. ~~In examining and reporting on the appropriateness of the going concern presumption, it is important that directors should be aware of the significance attached to the technical meaning of some of the terms used in connection with financial statements.~~
10. ~~Financial statements in the UK are drawn up under a framework of generally accepted accounting practices. A distinction is made between fundamental accounting concepts, accounting bases and accounting policies. Fundamental accounting concepts are the broad basic assumptions which underlie the way in which financial statements are drawn up. In contrast, accounting bases are the methods which have been developed for expressing or applying the fundamental accounting concepts to particular financial transactions and~~

~~items. Where there are several acceptable accounting bases, a company can choose the particular treatment (known as an 'accounting policy') which is the best to present fairly its results and financial position. It generally has no choice in the fundamental accounting concepts to which it should conform.~~

### The going concern concept

11. The going concern concept is a fundamental accounting concept and, as such, underlies the preparation of financial statements. The Companies Act ~~2006~~1985 also requires that the company shall be presumed to be carrying on business as a going concern' (see for example paragraph 11 of Part 2 of Schedule 1 to "The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008").

### Definition of going concern

12. The IASB Framework Statement of Standard Accounting Practice 2 'Disclosure of accounting policies' (SSAP2) ~~describes~~ defines the fundamental accounting concept 'going concern' as an underlying assumption meaning that the entity enterprise will continue in operational existence for the foreseeable future and that the entity has neither the intention nor the need to liquidate or curtail materially the scale of its operations.
13. Preparing financial statements on Tthe going concern basis is therefore unlikely to be compatible with the intention or the necessity to:
  - enter into a scheme of arrangement with the company's creditors (under section 895 of the Companies Act 2006);
  - make an application for an administration order; or
  - place the company into administrative receivership or liquidation.
14. ~~In recent years it has become~~It is commonplace for companies to ~~be~~ restructured. Some companies regard this as an ongoing process since they need to adapt to changing markets if they are to continue to be successful. It is generally accepted that such major restructuring does not adversely affect the suitability of the going concern basis for drawing up the financial statements.
15. The generally recognised alternative to the going concern basis is to assume that the company will be broken up. This may significantly diminish the carrying amount~~value~~ of assets previously reported in the balance sheet since it assumes that the assets will be subject to a forced sale and not realised in the normal course of business.

## Foreseeable future

- ~~16. SSAP 2 uses the term 'foreseeable future' without further elaboration. Neither the Companies Act 1985 nor accounting standards expand on that term in the context of going concern. However, for practical purposes some guidance is felt to be helpful.~~
17. Any consideration involving the foreseeable future involves making a judgment, at a particular point in time, about future events which are inherently uncertain. The following should be noted.
- (a) In general terms, the degree of uncertainty increases significantly the further into the future the consideration is taken. The manner in which the uncertainty increases with time depends on the circumstances of each particular company.
  - (b) The judgment is valid only at the time at which it is given. Subsequent events can overturn a judgment which was reasonable at the time at which it was made.
18. Accordingly, the foreseeable future depends on the specific circumstances at a point in time, including the nature of the company's business, its associated risks and external influences.
19. As a consequence, it is not possible to give any certainty in relation to going concern. Any judgment made, whilst reasonable at the time, can be valid only at that time and can be overturned by subsequent events.
20. In assessing going concern, directors should take account of all information of which they are aware at the time. It is not possible to specify a minimum period to which they should pay particular attention in assessing going concern. It is recognised that any such period is artificial and arbitrary; in reality there is no 'cut off point' after which there should be a sudden change in the approach adopted. Where the period considered by the directors has been limited, for example, to a period of less than one year from the date of approval of the financial statements, the directors should determine whether, in their opinion, the financial statements require any additional disclosure to explain adequately the assumptions that underlie the adoption of the going concern basis<sup>5</sup>.

## Use of going concern basis

21. Because going concern is a fundamental accounting concept, the directors usually prepare financial statements on the going concern basis; the alternative 'break-up' basis is very

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<sup>5</sup> If the period to which the directors have paid particular attention is less than one year from the date of approval of the financial statements the auditor is required by ISA (UK and Ireland) 570 "Going concern" to disclose that fact in the auditor's report. If the auditor considers that the future period to which the directors have paid particular attention is not reasonable in the company's circumstances this leads to a qualified auditor's report as the auditor is unable to obtain all the information and explanations which they consider necessary for the purpose of their audit.

unusual. Thus the directors may have identified factors which cast doubt on the presumption that the company will continue in operational existence for the foreseeable future but such doubts are most unlikely to make an alternative basis appropriate. In such cases, additional disclosure is appropriate.

22. Where such matters impact on the truth and fairness of the view given by the financial statements, then disclosure will be required in a note to the financial statements. Where it does not impact, then disclosure in the [Business Review section of the Directors' Report](#) ~~Operating and Financial Review ('OFR')~~ will be sufficient.

## **Insolvency**

23. Doubts on 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. The solvency of a company is determined by reference to a comparison of its assets and liabilities and by its ability to meet liabilities as they fall due. Nevertheless, if doubts relating to going concern are disclosed, there may be an adverse effect on public perception of the company's position. Where the directors are unable to state that the going concern basis is appropriate, they should consider taking professional advice.

## **PROCEDURES**

### **General**

24. There are many factors which are relevant to the directors in considering whether the company will continue in operational existence for the foreseeable future and hence as a going concern. Some are within, some outside, their control. The directors will need to consider these factors when they prepare budgets and forecasts. Work in support of their going concern statement can thus be integrated with other procedures that are carried out.
25. Directors are best placed to know 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. The relative significance of factors can also vary over time.
26. Some major areas in which procedures are likely to be appropriate are set out below. They may contain some matters which the directors consider do not apply to their company. They should, however, be given some consideration to see whether they could become significant.
27. The categories set out below are not exhaustive but indicate the main types of procedures relevant to considering going concern. The use of such categories is a matter of

convenience, since in practice points are often inter-related. More detailed procedures are included in the Appendix.

### Forecasts and budgets

28. Forecasting and budgeting are long-established techniques in management accounting. When the critical assumptions are challenged and tested, the refined forecasts and budgets can become powerful predictive techniques.
29. [Consistent with the guidance in IAS 1 B](#)udgets and forecasts, [for the entity as a whole](#), should be prepared to cover the period to the next balance sheet date as a minimum. They may be prepared on a rolling basis for at least twelve months ahead. Further periods are generally covered by medium or long term plans which give an indication in general terms of how the directors expect the business of the company to fare.

[29A IAS 36 “Impairment of Assets” \(paragraphs 30 to 53\) establishes more detailed requirements for the directors when making best estimates of future cash flows in relation to the calculation of the “value in use” of an asset.](#)

### Borrowing requirements

30. The facilities available to the company should be reviewed and compared to the detailed cash flow forecasts for the period to the next balance sheet date, as a minimum. Sensitivity analyses on the critical assumptions should also be used in the comparison. The directors should seek to ensure that there are no anticipated:
  - shortfalls in facilities against requirements;
  - arrears of interest; or
  - breaches of covenants.

[The directors’ use sensitivity analysis to assess whether the headroom, between cash requirements and facilities available, is sufficient.](#)

31. The directors have responsibility to manage borrowing requirements actively. Any potential deficits, arrears or breaches should be discussed with the company's bankers in order to determine whether any action is appropriate. 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. [IFRS 7 “Financial Instruments: Disclosures” requires disclosure to be made of defaults on borrowings and certain breaches of covenants.](#)
32. The directors may seek confirmation from their bankers regarding the existence and status of any finance arrangements which the company has entered into.

## Liability management

33. 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 which may be recorded off-balance sheet.

## Contingent liabilities

34. Directors should consider the company's exposure to contingent liabilities. ~~Not only should the directors consider contingent liabilities experienced by the company in the past~~ such as legal proceedings, guarantees, ~~and product liability~~ and ~~but they should also consider whether there are any new contingencies such as~~ environmental clean-up costs.

## Products and markets

35. Directors should have 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 markets.
36. Directors should ensure that their products are compatible with their market projections in terms of market position, quality and expected life.

## Financial risk management

37. There are many types of financial risk facing a company and directors should identify which risks are most significant to their company. For example, the exposure to fixed price contracts and to movements in foreign currency rates may be the most significant risks for a construction company exporting overseas. The directors should consider how such risks could affect the company and decide how best to manage these. [IFRS 7 requires directors to disclose what financial risks they face and their objectives, policies and processes for managing these risks.](#)

## Other factors

38. There are many other factors which could affect the ability of a company to continue in operational existence. Directors should consider how sensitive the company has been to particular past events; they can use this information to assess the likely effect of any potential recurrence of such events.
39. Although knowledge of the past is helpful, it cannot be used in isolation to predict the sensitivity of the company to future events. The directors should use their understanding

of the company, its resources and the state of the markets in which it operates to determine the key factors which could affect the company's future.

### Financial adaptability

40. Financial adaptability is the ability to alter the amounts and timing of cash flows to respond to unexpected needs or opportunities. As such, it can mitigate any of the factors above.

### Assessment Factors

41. When directors have undertaken all the individual procedures they consider appropriate, they should consider the range of potential outcomes in the context of the probability of occurrence to determine the likely commercial outcomes. They should also be aware of the implications arising from interaction between the various factors.
42. If the directors become aware of factors that cast doubt on the ability of the company to continue in operational existence, then they will need to carry out more detailed investigations to determine how the company can be best placed to overcome any such problems. Such work will provide evidence in support of their statement on going concern and additional disclosure in their statement may be appropriate.

## DISCLOSURE BY DIRECTORS

### Location of disclosure [of going concern statement](#)

43. Directors should include their statement on going concern in the [Business Review section of the Directors' Report, Operating and Financial Review](#) [The purpose of the Business Review is to enable members of the company to assess how the directors have performed their duty to promote the success of the company.](#)
44. The [Business Review OFR](#) incorporates a significant amount of discussion and analysis [about business risks](#) which will help to put the statement on going concern in context. Directors should be aware, however, that the [Business Review OFR is a review](#) relating primarily to past operations and will not necessarily contain sufficient disclosure for going concern purposes. To the extent that they see new [risk](#) factors arising or likely to arise in the future or changes to historical factors discussed in the [Business Review OFR](#), they will need to consider making appropriate additional disclosure in the [Business Review OFR](#) to support their going concern statement.
45. Directors should also be aware of the need to consider whether there needs to be a specific cross-reference between the going concern statement in the [Business Review OFR](#) and the accounting policy note in the financial statements. If there are doubts as to the appropriateness of the going concern presumption then the financial statements may need

to reflect any relevant factors in greater detail if they are to show a true and fair view. [IAS 1 “Presentation of Financial Statements” requires additional disclosures where management is aware of material uncertainties that may cast significant doubt about the ability of the company to continue as a going concern.](#)

46. The directors' going concern disclosure will form a part, albeit a significant one, of the indications about the future of the company that are being conveyed by the annual report and accounts.

### **Content of disclosure**

47. When directors have weighed up the results of the procedures they have undertaken, there are ~~four~~<sup>three</sup> basic conclusions they can reach:

- they have a reasonable expectation that the company will continue in operational existence for the foreseeable future and have therefore used the going concern basis in preparing the financial statements;
- they have identified factors which cast doubt on the ability of the company to continue in operational existence for the foreseeable future but they consider that it is appropriate to use the going concern basis in preparing the financial statements;
- [they have identified material uncertainties that may cast significant doubt about the ability of the company to continue as a going concern and so additional disclosures are required by IFRSs;](#)
- they consider that the company is unlikely to continue in operational existence for the foreseeable future and therefore the going concern basis is not an appropriate one on which to draw up the financial statements.

### **Going concern presumption appropriate**

48. In many cases, the detailed budgets will indicate that the position of the company will be satisfactory for the period covered by those budgets and the longer-term plans of the company will contain no indications to suggest the company may cease to continue in operational existence. In such cases, the additional work needed by the directors to support their going concern statement should be relatively small, since the nature of the work will be a drawing together and formal documentation of existing work and evidence.
49. When the directors have been able to satisfy themselves that the going concern presumption is appropriate, they should make a basic statement to that effect. A suggested example of the basic disclosure is as follows:

*'After making enquiries, the directors have a reasonable expectation that the company has adequate resources to continue in operational existence for the foreseeable future. For this reason, they continue to adopt the going concern basis in preparing the accounts.'*

### **Going concern basis used despite doubts on going concern presumption**

50. In most cases, directors will need to draw up financial statements on the going concern basis. When there are factors which, in the event of an unfavourable outcome, cast doubt on the appropriateness of the going concern presumption, the directors will need to perform more detailed work to determine the extent of the problem and the company's ability to respond to it. In making their statement on going concern, the directors should explain the circumstances so as to identify the factors which give rise to the problems (including any external factors outside their control which may affect the outcome) and an explanation of how they intend to deal with the problem so as to resolve it.

51. As an example, the disclosure for a company where there is a breach of covenants and negotiations are continuing might be along the following lines:

*'The company is in breach of certain loan covenants at its balance sheet date and so the company's bankers could recall their loans at any time. The directors continue to be involved in negotiations with the company's bankers and as yet no demands for repayments have been received. The negotiations are at an early stage and, although the directors are optimistic about the outcome, it is as yet too early to make predictions with any certainty'.*

*'In the light of the actions described elsewhere in the [Business Review Operating and Financial Review](#), the directors consider it appropriate to adopt the going concern basis in preparing the accounts.'*

51A Where the directors conclude that significant doubt exists about the company's ability to continue as a going concern, additional disclosures are required by IFRSs and are likely to be more extensive than that required by the above guidance. Such disclosures are likely to be very specific to the company's circumstances and so a suggested text is not included here.

### **Going concern basis not appropriate**

52. Where, as a result of the procedures that they have undertaken, the directors consider the company is unlikely to continue in operational existence for the foreseeable future, they should no longer prepare the financial statements using the going concern assumption, and an alternative basis will have to be used.

53. The directors will need to state that, in their opinion, the company is no longer a going concern; they should, however consider taking legal advice on the wording of their statement.

54. Where the company is not a going concern, the company is not necessarily insolvent. The directors should, however, consider whether the company may be or become insolvent or whether section 214 of the Insolvency Act 1986 applies. This section states that an action for wrongful trading may be brought against a director if at some time before the commencement of the winding up of the company he knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation.

## **OTHER ISSUES**

### **Application to groups of companies**

55. The directors of a parent company preparing group financial statements should make their statement regarding going concern in respect of both the parent company and the group as a whole. A statement in relation to the group does not imply that each of the companies within the group is a going concern.

### **Relevant date for disclosure**

56. The statement by the directors should be made in accordance with what is known to them at the date on which they approve the financial statements; in practice directors will need to perform their work to a date before the approval of the financial statements and update their work as appropriate.

### **Interim reporting**

57. Listed companies are required to publish [half yearly financial reports \(including an interim management report\)](#)~~interim results~~ [and interim management statements during both the first and second six month period of its financial year.](#) Directors cannot be expected to consider going concern as fully at the interim, but they should undertake a review of their previous work. They should look at the position at the previous year end to see whether any of the significant factors which they had identified at that time have changed in the interim to such an extent as to affect the appropriateness of the going concern presumption. ~~More detailed consideration is being given to interim reporting by other parties.~~

## APPENDIX

### DETAILED PROCEDURES

This appendix sets out a list of detailed procedures which may be helpful to directors, particularly of smaller listed companies, in determining the appropriateness of the going concern basis in drawing up the accounts. It is not intended to be used as a checklist, since there may be other procedures, not detailed below, which are relevant for a particular company and, conversely, not all the procedures will be appropriate for every company.

#### 1. FORECASTS AND BUDGETS

- 1.1 Directors may prepare monthly cash flow forecasts and monthly budgets covering, as a minimum, the period up to the next balance sheet date.
- 1.2 Directors may prepare a detailed list of assumptions (including macro-economic assumptions) which underlie the forecasts. In relation to these assumptions, the directors may confirm that:
  - attainable gross profits are realistic and consistent with past performance, the existing and anticipated pricing structure and order book;
  - sales mix and yield are realistic;
  - the patterns of debtor collections are realistic and consistent with current debtor collections;
  - stock holding and work in progress levels and usage are realistic and realisable;
  - working capital requirements are realistic and based on past performance;
  - the basis of payment terms with existing creditors is attainable and realistic in the light of existing liabilities and credit facilities available; and
  - overhead levels are realistic in the light of past performance.
- 1.3 Directors may consider which assumptions are critical to their business; all critical assumptions may be noted and subjected to sensitivity analysis.
- 1.4 Directors may consider whether the forecasts take adequate account of capital asset replacement programmes.
- 1.5 Directors may consider whether the forecasts adequately provide for escalating costs (eg due to inflation or contractual terms).

- 1.6 Directors may ensure that seasonal fluctuations are reflected in the forecasts; in particular that any necessary stock build-ups (for example of Christmas stock) are adequately provided for.
- 1.7 Directors may consider the availability of key resources and how shortages could affect the projected outcomes.
- 1.8 Directors may perform sensitivity analyses on the critical assumptions, particularly in relation to differing levels of activity.
- 1.9 Directors may consider the accuracy of past forecasts over the recent years; any significant variances may be analysed and documented and the directors may consider whether current forecasts need revising to avoid the same tendencies.

## **2. BORROWING REQUIREMENTS**

- 2.1 Directors may confirm that the covenants on current borrowings are satisfied as at the balance sheet date.
- 2.2 Directors may confirm that there are no arrears of interest on current borrowings as at the balance sheet date. The term 'arrears' does not include accruals but relates to interest past the due date for payment.
- 2.3 Directors may compare monthly forecast cash flow positions with facilities available to ensure that there is no projected deficit (this should assume that all interest payments can be made on the due dates). This may be done for the period to the next balance sheet date. Directors may consider how they could cover any deficit or interest arrears; this could include renegotiating the facilities with the company's bankers.
- 2.4 Directors may perform sensitivity analyses using the worst estimates of key assumptions in the forecasts to ensure that facilities are adequate. Where facilities are inadequate to cover borrowings, the directors may consider how they could cover this as in 2.3 above.
- 2.5 Directors may test budgeted numbers against all existing covenants to ensure that there are no anticipated breaches. This may be done on a monthly basis for the period to the next balance sheet date. If the forecasts do indicate likely breaches, the directors may consider how they could prevent these as in 2.3 above.
- 2.6 Directors may test for breach of covenant against forecasts prepared on the basis of the worst assumptions; again, they may consider what action to take where the covenants could be breached.

## **3 LIABILITY MANAGEMENT**

- 3.1. Directors may schedule all known liabilities and repayment dates in the future. (This goes beyond the period to the next balance sheet date and is determined by all known liabilities including commitments).

- 3.2 Directors may consider whether there are any periods when large repayments coincide and there are no matching, projected inflows of funds. Particular consideration may be given to high priority cash flows such as excise duties and taxation. Where there are projected outflows unmatched by inflows, directors may consider how the funds will be raised and whether appropriate arrangements can be put in place to meet payments as they fall due.
- 3.3 Directors may take into account any other commitments, which may be off-balance sheet (for example operating lease commitments and forward exchange contracts), when assessing the profile of loan repayments.
- 3.4 Directors may calculate those financial ratios appropriate to the company's business, for example the gearing ratio and interest cover. Historical trends in these ratios should be noted and budgets should be used to assess how these are likely to change to the extent not covered by the work on covenants above.
- 3.5 Directors may consider whether the company places undue reliance on overdue suppliers' accounts and whether other creditors (such as VAT, PAYE and NI) are overdue. In this context, directors may calculate creditor days on a monthly basis for the past year to determine historical trends and to ensure that there is no evidence of deterioration. Figures for creditor days may be compared to stated credit terms and industry averages. Any restrictions placed by suppliers on usual trade terms may be investigated. This analysis may also be performed using the forecast information.
- 3.6 Directors may consider the extent of the company's reliance on a limited number of suppliers. They may consider whether there are agreements with key suppliers and what plans have been made to ensure continuity of supply.

#### **4. CONTINGENT LIABILITIES**

- 4.1 Directors may consider the exposure of the company to contingent liabilities, in particular those arising through:
- legal proceedings;
  - guarantees and/ or warranties;
  - product liability not covered by insurance; and
  - retentions.
- 4.2 Where the company has been in receipt of grants for revenue or capital expenditure and there are conditions attaching to those grants, the directors may consider whether there has been or is likely to be a breach of conditions such that a repayment is or will be due.

- 4.3 Directors may consider whether the company has a current or potential liability for environmental 'clean-up' costs.
- 4.4 Directors may consider any potential exposure for decommissioning costs.
- 4.5 Directors may consider the extent and potential effect of any intra-group guarantees, for example unlimited multi-lateral guarantees.

## **5. PRODUCTS AND MARKETS**

- 5.1 For each of the main product markets, directors may consider the size of the market and its strength and assess whether there are any economic, political or other factors which may cause the market to change.
- 5.2 Directors may consider the position of the company's products in its markets and how these have changed over time and are likely to change in the foreseeable future.
- 5.3 Directors may review whether the quality of the products is consistent with the projected demand.
- 5.4 Directors may determine whether the products will become obsolete quickly and, if so, that stock controls are adequate to minimise wastage whilst avoiding stock-outs.
- 5.5 Directors may consider whether there is adequate but not excessive product and allied research and technical development and whether this will be maintained at an appropriate level in the foreseeable future.
- 5.6 Directors may consider the adequacy of their marketing strategy to secure future market shares as projected in forecasts.
- 5.7 Directors may consider the adequacy of their costing systems. In particular, they may review the accuracy of costing, how frequently the costs are updated and the extent to which product contributions are used. This can also provide the directors with comfort on forecast profit margins.
- 5.8 Directors may review the bases for overhead allocations and how frequently these are updated. The performance measurement of profit centres and cost centres may be reviewed and acted upon in order to maintain the performance of the business as a whole.
- 5.9 Directors may consider the mix of customers and whether the company's turnover is dependent on too limited a number. Directors may evaluate the risk of losing these customers, for example by reviewing the customers themselves, their activities and whether these are changing. Directors may also consider the likelihood of finding alternative sales markets where there appears to be a high risk of losing their existing customers.

5.10 Directors may review the dependence of the company on intra-group trading. In particular, directors may consider whether transactions have been made at arm's length and whether management charges are for value.

## **6. FINANCIAL RISK MANAGEMENT**

6.1 Directors may consider their current and anticipated approaches to managing risk arising through adverse movements in interest rates. Where assumptions about interest rates critically affect the projected future position of the company, sensitivity analyses may be performed.

6.2 Directors may consider their current and anticipated approaches to managing risk arising through adverse movements in foreign currency exchange rates. Where assumptions about foreign currency exchange rates critically affect the projected future position of the company, sensitivity analyses may be performed.

6.3 Directors may consider their current and anticipated exposures to risk through major fixed price or fixed rate contracts. Past and projected costs on such contracts may be regularly reviewed.

## **7. OTHER FACTORS**

7.1 Other factors which directors may take into account when determining the appropriateness of the going concern presumption include:

- consistency of earnings;
- stability of cost base;
- recurring operating losses;
- alternating operating profits and losses in subsequent years;
- arrears of dividends;
- current dividends being paid out of retained rather than current earnings;
- non-compliance with statutory capital requirements;
- work stoppages or other labour difficulties;
- loss of key management or staff (directors may consider how easily they could be replaced);
- loss of a key patent or franchise;
- high levels of stock which may include obsolete stock;

- long overdue debtors;
- potential losses on long-term contracts;
- continuing use of old fixed assets because there are no funds to replace them (potentially identified through any of the following: increased maintenance costs, increased down-time or problems with quality control); and
- adequacy of the company's insurance policies.

7.2 Directors may consider whether there are signs that the company is overtrading.

## 8. FINANCIAL ADAPTABILITY

- 8.1 Financial adaptability is defined by the Accounting Standards Board as the ability of a company to take effective action to alter the amounts and timing of *its* cash flows so that it can respond to unexpected needs or opportunities. [\(See ASB's "Revised Statement of Principles for Financial Reporting".\)](#)
- 8.2 Financial adaptability mitigates the factors above in considering the appropriateness of the going concern presumption in relation to the company.
- 8.3 In determining the financial adaptability of a company, the directors may consider 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.

## Developments in International Financial Reporting Standards since 1994 relating to going concern

### The position in 1994

The Guidance for Directors was first issued in 1994, at which time references to the Going Concern concept in accounting standards were quite scarce. In UK standards, SSAP 2 identified going concern as one of the four fundamental accounting concepts underlying the periodic financial accounts of business enterprises.

SSAP 2 noted that the use of these fundamental accounting concepts is not necessarily self evident from an examination of accounts, but they have such general acceptance that they call for no explanation in published accounts and their observance is presumed unless otherwise stated. It stated that the generally accepted, meaning of “going concern” was:

“the enterprise will continue in operational existence for the foreseeable future. This means in particular that the profit and loss account and balance sheet assume no intention or necessity to liquidate or curtail significantly the scale of operation”.

In 1994, the Framework underpinning International Accounting Standards followed similar thinking and stated:

“The financial statements are normally prepared on the assumption that an entity is a going concern and will continue in operation for the foreseeable future. Hence, it is assumed that the entity has neither the intention nor the need to liquidate or curtail materially the scale of its operations; if such an intention or need exists, the financial statements may have to be prepared on a different basis and, if so, the basis is disclosed”.

### Developments since 1994

Since 1994 the requirements of accounting standards relating to going concern has increased significantly. With respect to IFRSs the following significant requirements have been introduced<sup>6</sup>:

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<sup>6</sup> The discussion in this section addresses developments in IFRSs. There have been similar developments in UK GAAP. Directors of those listed companies that have retained UK GAAP for their parent company accounts will, therefore, have to consider these two sets of accounting literature.

- An active requirement for management to assess going concern.
- Guidance on what is meant by the foreseeable future.
- Evidence of going concern status from subsequent events.
- Increased disclosure requirements with respect to liquidity risk.
- Detailed requirements on how to estimate future cash flows relating to impaired assets.
- The disclosure of estimation uncertainty.

These are discussed in further detail in the following paragraphs.

#### *Active requirement for management to assess going concern*

IAS 1 “Presentation of Financial Statements” has introduced a requirement for management to make an active assessment of an entity’s ability to continue as a going concern.

**“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. When management is aware, in making its assessment, of material uncertainties related to events or conditions that may cast significant doubt upon the entity’s ability to continue as a going concern, the entity shall disclose those uncertainties. When an entity does not prepare financial statements on a going concern basis, it shall disclose that fact, together with the basis on which it prepared the financial statements and the reasons why the entity is not regarded as a going concern.”<sup>7</sup>**

#### *Guidance on foreseeable future*

The guidance that follows this requirement provides some insight into “foreseeable future”. It states “In assessing whether the going concern assumption is appropriate, management takes into account all available information about the future, which is at least, but is not limited to, twelve months from the end of the reporting period. ...”

It should be noted that the definition of the foreseeable future in IAS 1 of “twelve months from the end of the reporting period” is shorter than the definition in the Guidance for Directors which is “one year from the date of approval of the financial statements”<sup>8</sup>. However the period in IAS 1 is consistent with the requirement relating to forecasts and budgets in the Guidance for

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<sup>7</sup> IAS 1 paragraph 25

<sup>8</sup> See paragraph 20 of Guidance for Directors

directors which is that they “should be prepared to cover the period to the next balance sheet as a minimum”<sup>9</sup>.

### *Evidence of going concern status from subsequent events*

IAS 10 “Events after the reporting period” requires “**An entity shall not prepare its financial statements on a going concern basis if management determines after the reporting period either that it intends to liquidate the entity or to cease trading, or that it has no realistic alternative but to do so**”<sup>10</sup>.

Guidance following this requirement notes “Deterioration in operating results and financial position after the reporting period may indicate a need to consider whether the going concern assumption is still appropriate. If the going concern assumption is no longer appropriate, the effect is so pervasive that this standard requires a fundamental change in the basis of accounting, rather than an adjustment to the amounts recognised within the original basis of accounting”.

### *Disclosures relating to liquidity risk*

A significant risk to the validity of the going concern presumption is “liquidity risk”. Liquidity risk is the risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities and may arise because of the possibility that the entity could be required to pay its liabilities earlier than expected. IAS 1 notes that “Information about expected dates of realisation of assets and liabilities is useful in assessing the liquidity and solvency of an entity”<sup>11</sup>. In this connection IFRS 7 “Financial Instruments: Disclosures” requires an entity to make certain qualitative disclosures, arising from financial instruments, with respect to liquidity risk:

- **the exposure to liquidity risk and how it arises;**
- **the objectives, policies and processes for managing liquidity risk and the methods used to measure the risk; and**
- **any changes in these exposures since the prior period**<sup>12</sup>.

IFRS 7 also requires. “**summary quantitative data about liquidity risk based on the information provided to key management personnel of the entity; and concentrations of liquidity risk**”<sup>13</sup>.

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<sup>9</sup> See paragraph 29 of Guidance for Directors

<sup>10</sup> IAS 10 paragraph 14

<sup>11</sup> IAS 1 paragraph 65

<sup>12</sup> Paraphrased from IFRS 7 paragraph 33

<sup>13</sup> Paraphrased from IFRS 7 paragraph 34

Where liquidity risk is material IFRS 7, in particular, requires an entity to disclose:

- (a) “a maturity analysis for financial liabilities that shows the remaining contractual maturities; and**
- (b) a description of how it manages the liquidity risk inherent in (a)”<sup>14</sup>.**

IFRS 7 also requires disclosure, by class of financial asset, of:

- (a) “an analysis of the age of financial assets that are past due as at the end of the reporting period but not impaired; and**
- (b) an analysis of financial assets that are individually determined to be impaired as at the end of the reporting period...”<sup>15</sup>.**

### *Estimating future cash flows*

Significant questions about going concern also often accompany triggers for impairment testing of assets. IAS 36 “Impairment of Assets” includes detailed requirements when estimating future cash flows to determine future value in use to an entity. With respect to the basis for estimates of future cash flows:

**“In measuring value in use an entity shall:**

- (a) base cash flow projections on reasonable and supportable assumptions that represent management’s best estimate of the range of economic conditions that will exist over the remaining useful life of the asset. Greater weight shall be given to external evidence.**
- (b) base cash flow projections on the most recent financial budgets/forecasts approved by management ...Projections based on these budgets/forecasts shall cover a maximum period of five years, unless a longer period can be justified.**
- (c) estimate cash flow projections beyond the period covered by the most recent budgets/forecasts by extrapolating the projections based on the budgets/forecasts using a steady or declining growth rate for subsequent years, unless an increasing rate can be justified...”<sup>16</sup>.**

With respect to the composition of estimates of future cash flows IAS 36 requires that:

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<sup>14</sup> IFRS 7 paragraph 39

<sup>15</sup> IFRS 7 paragraph 37

<sup>16</sup> IAS 36 paragraph 33

**“Estimates of future cash flows shall include:**

- (a) projections of cash inflows from the continuing use of the asset;**
- (b) projections of cash outflows that are necessarily incurred to generate the cash inflows from continuing use of the asset ...and can be directly attributed or allocated on a reasonable and consistent basis, to the asset; and**
- (c) net cash flows, if any to be received (or paid) for the disposal of the asset at the end of its useful life”<sup>17</sup>.**

*Disclosure of estimation uncertainty*

A relatively recent requirement introduced into IAS 1 concerns its disclosure requirements relating to sources of estimation uncertainty. It requires:

**“An entity shall disclose information about the assumptions it makes about the future, and other major sources of estimation uncertainty as the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year. In respect of those assets and liabilities, the notes shall include details of:**

- (a) their nature, and**
- (b) their carrying amount as at the end of the reporting period”<sup>18</sup>.**

Guidance in IAS 1 notes that examples of the type of disclosures an entity makes are:

- (a) the nature of the assumption or other estimation uncertainty;
- (b) the sensitivity of carrying amounts to the methods, assumptions and estimates underlying their calculation, including the reasons for the sensitivity;
- (c) the expected resolution of an uncertainty and the range of reasonably possible outcomes within the next financial year in respect of the carrying amounts of the assets and liabilities affected; and
- (d) an explanation of changes made to past assumptions concerning those assets and liabilities, if the uncertainty remains unresolved<sup>19</sup>.

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<sup>17</sup> IAS 36 paragraph 39

<sup>18</sup> IAS 1 paragraph 125

<sup>19</sup> IAS 1 paragraph 129

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