



FINANCIAL REPORTING COUNCIL

STUDY: GOING CONCERN AND LIQUIDITY RISK DISCLOSURES

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One - Introduction

In May 2008, the Financial Reporting Council (FRC) commissioned a study of going concern and liquidity risk disclosures made by listed companies who reported in December 2007 and March 2008. The study sought to assess compliance with the requirements of the Listing Rules in relation to disclosures about the use of the going concern basis and compliance with International Financial Reporting Standard (IFRS) 7 (Financial instruments: disclosures) in relation to disclosures about liquidity risk.

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 as to whether the business is a going concern, together with supporting assumptions or qualifications as necessary.

IFRS 7 applied for the first time to December 2007 year ends, although early adoption was permitted. It requires a significant increase in disclosures about how liquidity risk is managed when it becomes a material financial risk.

These new IFRS disclosures require information seen “through the eyes of management”. In particular, IFRS 7 requires disclosure of how material financial risks, such as liquidity risk, are managed in practice together with supporting numerical disclosures drawn from summarised financial data used by key management personnel.

The FRC study examined the December 2007 or March 2008 annual reports of thirty UK entities within the population of UK listed and AIM companies. Companies were selected if they had issued a profit warning, announced a rescue rights issue or otherwise announced funding difficulties during the first half of 2008. Financial services businesses were excluded from the sample as the objective of the review was to examine disclosures by companies operating in the wider economy.

Two - Summary of results and conclusions

All companies disclosed in their Directors' Report that they had adequate resources to continue in operation for the foreseeable future and thus they had adopted the going concern basis in preparing their accounts. None added any additional cautionary comments, suggesting that there was nothing at the date of approval of the accounts that cast doubt on the ability of that company to continue as a going concern.

The study found that information about going concern and liquidity risk was included in many different places in the annual reports reviewed. This made it difficult to develop a coherent and comprehensive picture of how liquidity concerns were relevant to the businesses. Disclosures were sometimes to be found in the chairman's statement, chief executive's report, Directors' Report as well as in the notes to the accounts.

The study concluded that it would be particularly helpful if all of these disclosures could be brought together into a single section of a company's annual report and accounts as this would facilitate a better understanding. If this is not practical, it would be helpful if the key disclosures are brought together by way of a note including cross references to other disclosures to help readers of financial statements find all of the relevant pieces of information.

All but one of the companies identified liquidity risk as a material financial risk and all provided relevant details about bank facilities, assets pledged as security (if they existed) and details of the maturity of fixed term liabilities. However:

- For many companies, the disclosures were more generic than specific in nature. Only a minority of companies provided information that really shed light on how the business managed its day to day cash flow and borrowing levels.
- A conclusion could not be reached on whether disclosure had been made of summarised data about liquidity risk provided to key management personnel (generally the directors). This would have required access to internal company documentation.

Generic and inappropriately aggregated information hinders the ability of investors and lenders to understand the factors affecting the ability of the entity to continue as a going concern and how in practice liquidity issues are managed. Excessive disclosure about immaterial items that results in annual reports becoming unnecessarily complex should be avoided.

Overall the study concluded that the quality of going concern and liquidity disclosures reported by the thirty companies in the sample was follows:

Quality assessment	Number of companies
Data mostly limited to bank balances and borrowing facilities – restricted usefulness	17
Some company specific information about liquidity management – more useful	8
Company specific information about liquidity management – very useful	4
No liquidity risk data as no debt and substantial cash balances – not material	1
Total	30

These results demonstrate that there is a significant opportunity for companies to improve their liquidity risk disclosures. The effect of the deteriorating economy will result in liquidity risk being material for more companies for the foreseeable future resulting in more companies needing to provide the full IFRS 7 disclosures.

Three – Review of compliance by area

3.1 Going concern statement

The UK Listing Rules require directors to make a specific statement about going concern. The Guidance for Directors issued in 1994 provides guidance on the procedures that directors may wish to undertake and about the statement that they are required to make. That guidance also identifies a need to increase disclosures about going concern where the directors have identified factors which cast doubt on the ability of the company to continue in operational existence.

All of the companies included a statement in their Directors' Report that the directors had made enquiries and had a reasonable expectation that the company had adequate resources to continue in operational existence for the foreseeable future. None of the companies modified their statement to indicate the existence of factors which cast doubt on the company's ability to continue as a going concern.

3.2 Significant doubts about going concern

IAS 1.23 (subsequently 1.25) (IAS 1 - Presentation of financial statements) requires material uncertainties to be disclosed where those material uncertainties cast significant doubt upon the entity's ability to continue as a going concern.

None of the companies in the study reported that there were material uncertainties that cast significant doubt upon the ability of the company to continue as a going concern. Similarly, none of the audit reports included an emphasis of matter paragraph drawing attention to the going concern assumption.

3.3 How liquidity risk arises and is managed in practice

IFRS 7.31 sets out the overarching principle that companies should make all of the disclosures necessary to enable users of its financial statements to evaluate the nature and extent of liquidity risk in the business.

It was not possible to conclude whether this requirement had been met. Many companies provided detailed disclosures of aspects of liquidity issues and management of liquidity risk, but because these disclosures were distributed across different parts of the annual report it was difficult to form an overall view about whether the disclosures conveyed a comprehensive understanding relevant to the specific circumstances of each company.

The study findings in relation to the more detailed disclosures required by IFRS 7 were as follows.

3.3.1 How exposure to liquidity risk arises

IFRS 7.33 (a) requires disclosure of the exposure to liquidity risk and how it arises.

The study found that many companies had adopted standardised descriptions of liquidity risk and few contained specific information that formed a link to how the business operates and generates net cash inflows.

In many cases there was a simple statement that liquidity risk existed, but there was little specific comment about the issues that gave rise to liquidity exposures. For example, where relevant useful comment might have been made about reliance on customers not increasing their credit periods and how that risk is managed.

3.3.2 Objectives, policies and processes for managing liquidity risk

IFRS 7.33 (b) requires an entity to disclose its objectives, policies and processes for managing liquidity risk and the methods used to measure the risk.

IFRS 7.33 (c) requires an entity to disclose any changes to its exposure to liquidity risk, objectives, policies and process and methods of measurement when compared to the prior year.

All companies provided a short statement about their objectives in managing liquidity risk. A common comment was that the objective was to ensure that sufficient cash is maintained in order to meet liabilities as they fall due.

Eight companies provided some specific information about their liquidity risk management policies. However, these comments tended to be brief. For example, one company noted that its policy was to manage borrowings to fund ongoing operations without the need to carry significant net debt over the medium term. A discussion of the objectives and limits set by boards to govern the activities of group treasurers, and group treasury functions where they exist, would have been useful.

Only four companies provided very useful information about the processes that they use to manage liquidity risk. For the other reports reviewed, the quality of information about how liquidity risk was managed in practice generally fell short of that necessary to convey an understanding of whether management was in control of liquidity risk issues. A discussion of the process followed by group treasurers and their teams and how information was generated that enabled liquidity to be monitored by management would have been more useful.

An example, illustrating some of these disclosures is as follows:

“Liquidity risk reflects the risk that the Group will have insufficient resources to meet its financial liabilities as they fall due. The Group’s strategy to managing liquidity risk is to ensure that the Group has sufficient funds to meet all its potential liabilities as they fall due, including shareholder distributions. This is true not only of normal market conditions but also of negative projections against expected outcomes, so as to avoid any risk of incurring contractual penalties or damaging the Group’s reputation.

Liquidity forecasts are produced on a daily basis, to ensure the utilisation of current facilities is optimised; on a monthly basis to ensure that covenant compliance targets and medium-term liquidity is maintained; and on a long-term projection basis, for the purpose of identifying long-term strategic funding requirements. The Directors also continually assess the balance of capital and debt funding of the Group.”

None of the companies disclosed changes to their approach to managing liquidity risk as compared to the prior year. It is likely that significant disclosures in this area will arise in 2008, given the reduced credit availability and the deterioration in cash flow being experienced by companies in the wider (non-financial) economy.

3.3.3 Summary quantitative data about liquidity risk

IFRS 7.34 (a) requires disclosure of summary quantitative data about the exposure to liquidity risk based on the information provided internally to key management personnel.

All of the companies disclosed a range of quantitative data about cash, investments and other liquid assets, overdrafts, bank borrowings and term facilities.

However, these disclosures appeared to be very similar to those that would have been given in prior years to which IFRS 7 did not apply. It was not practical to identify which of these disclosures presented a summary of the information provided to key management personnel.

The study was unable to conclude that key amounts derived from internal management documents, such as board reports, had been disclosed as this would require access to internal company documents.

3.3.4 Maturity analysis of financial liabilities

IFRS 7.39 requires a maturity analysis for financial liabilities that shows the remaining contractual maturities.

All of the companies disclosed a table setting out contractual maturities, or explained the maturity profiles of the different borrowings in the relevant note to the financial statements. The study identified that these disclosures could in some cases have been usefully enhanced by adding the cash flow obligations of unrecognised liabilities, such as operating lease commitments.

3.3.5 Borrowing facilities

IAS 7.50 (IAS 7 - Cash flow statements) requires disclosure of the amount of undrawn borrowing facilities that may be available for future operating activities and to settle capital commitments, indicating any restriction on the use of these facilities, where it is relevant to users in understanding the financial position and liquidity of the company.

All but one of the companies in the sample provided disclosures about their borrowing facilities (one company had no debt). However, the level of detail varied greatly and in particular it was difficult to identify material restrictions on the use of these facilities. For example, only three companies provided any indication that there were covenants attached to these facilities and then only in general terms. An example, illustrating some of these disclosures is as follows:

“The Group holds a committed revolving credit facility of £40m which is to be used for general corporate and working capital purposes which expires in July 2009. As at 31 March 2008 the Group had available £8m (2007: £5m) of undrawn committed borrowing facilities with a floating charge over the Group’s assets; all conditions precedent had been met.”

Some listed companies have found it necessary to disclose details of their debt covenants by way of a regulatory news service announcement. It is likely that some companies will find it necessary to disclose details of their covenants in their future financial statements during these difficult economic conditions.

3.3.6 Defaults on borrowing facilities

IFRS 7.18 requires disclosure of all defaults of interest or principal or other payments on loans payable during the period and all loans payable in default at the year end. IFRS 7.19 requires disclosure of all other breaches of loan agreements during the period unless the breaches were remedied before the balance sheet date.

None of the companies reported any defaults on loans payable during the period. The incidence of defaults and breaches is likely to have risen during 2008 and will result in additional disclosures in future financial statements.

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