Going Concern Issues During the Current Economic Conditions

December 2008

BULLETIN

2008/10

The Auditing Practices Board

THE AUDITING PRACTICES BOARD

The Auditing Practices Board (APB), which is part of the Financial Reporting Council (FRC), prepares for use within the United Kingdom and Republic of Ireland:

- Standards and guidance for auditing;
- Standards and guidance for reviews of interim financial information performed by the auditor of the entity;
- Standards and guidance for the work of reporting accountants in connection with investment circulars; and
- Standards and guidance for auditor's and reporting accountant's integrity, objectivity and independence

with the objective of enhancing public confidence in the audit process and the quality and relevance of audit services in the public interest.

The APB comprises individuals who are not eligible for appointment as company auditors, as well as those who are so eligible. Those who are eligible for appointment as company auditors may not exceed 40% of the APB by number.

Neither the APB nor the FRC accepts any liability to any party for any loss, damage or costs howsoever arising, whether directly or indirectly, whether in contract, tort or otherwise from any action or decision taken (or not taken) as a result of any person relying on or otherwise using this document or arising from any omission from it.

The purpose of Bulletins issued by the APB is to provide auditors and, where relevant, reporting accountants with timely guidance on new and emerging issues. They are persuasive rather than prescriptive. However, they are indicative of good practice, even though they may be developed without the full process of consultation and exposure used for auditing standards.

ISBN 978-1-84798-136-3

THE AUDITING PRACTICES BOARD

GOING CONCERN ISSUES DURING THE CURRENT ECONOMIC CONDITIONS

Contents — ***Paragraphs***

INTRODUCTION

1. Current economic conditions provide particular challenges to all involved with annual reports and accounts. One consequence is expected to be an increase in the disclosures in annual reports and accounts about going concern and liquidity risk. As a result, the current conditions will present challenges for:

   (a) directors – who will need to ensure that they prepare thoroughly for their assessment of going concern and make appropriate disclosures; and

   (b) auditors – who will need to ensure that they fully consider going concern assessments and only refer to going concern in their auditor's reports when appropriate.

2. In January 2008 the Auditing Practices Board (APB) issued Bulletin 2008/1[1] to provide guidance on matters that auditors needed to consider when conducting audits in the economic environment that was, at that time, characterised as the ''credit crunch''.

3. Since then the economic environment has worsened and the UK and Irish economies are entering a period of recession. This economic environment leads to added uncertainty regarding:

   (a) bank lending intentions and the availability of finance more generally;

   (b) the impact of the recession on a company's own business; and

   (c) the impact of the recession on counterparties, including customers and suppliers.

   These conditions will create a number of challenges for the preparers of financial statements and their auditors.

4. The effect of the current market conditions on any particular entity requires careful evaluation. However, the general economic situation at the present time does not, of itself, necessarily mean that a material uncertainty exists about an entity's ability to continue as a going concern or justify auditors modifying their auditor's reports to draw attention to going concern. The auditor makes a judgment on the need, or otherwise, to draw attention to going concern on the basis of the facts and circumstances of the entity at the time of signing the auditor's report. This Bulletin gives guidance on relevant factors to be considered and highlights certain requirements and guidance in the ISAs (UK and Ireland).

---

1 Bulletin 2008/1 ''Audit Issues when Financial Market Conditions are Difficult and Credit Facilities may be Restricted''.

5. This Bulletin supplements Bulletin 2008/1 and in particular:

   (a) updates the list of risk factors included in that Bulletin (see appendices 2 and 3); and

   (b) provides guidance on a number of going concern issues that auditors are likely to encounter during the forthcoming reporting cycle.

   This guidance draws on ISA (UK and Ireland) 570 ''Going concern'' and does not establish any new requirements.

6. To assist directors, the Financial Reporting Council (FRC), has published guidance entitled ''An update for directors of listed companies: going concern and liquidity risk'' (Update for Directors). Its purpose is to bring together existing guidance in the context of recent developments relating to going concern and liquidity risk disclosures to assist directors, audit committees and finance teams of listed companies during the forthcoming reporting season. It is expected that this Update for Directors will also be useful to directors of unlisted companies and other entities who have similar responsibilities to assess going concern and make appropriate disclosures. This Update for Directors is attached as Appendix 1 to this Bulletin.

7. As with Bulletin 2008/1, this Bulletin has been written by reference to the challenges arising in relation to audits of all entities. The challenges arising in relation to audits of financial institutions such as banks, insurance companies and investment businesses give rise to additional specialist considerations that are not addressed in this Bulletin.

THE POTENTIAL IMPACT OF THE ECONOMIC OUTLOOK ON THE DIRECTORS' APPROACH TO ASSESSING GOING CONCERN

8. Accounting standards (both IFRS and UK GAAP) require directors to:

   (a) make an assessment of a company's ability to continue as a going concern when preparing financial statements, and

   (b) disclose the uncertainties that the directors are aware of in making their assessment of going concern where those uncertainties may cast significant doubt on the company's ability to continue as a going concern.

9. The APB believes that the FRC's publication of the Update for Directors will assist auditors as it emphasises the need for directors to apply an appropriate degree of rigour and formality when making their judgments and suggests that directors will need to plan their assessment of going concern as early as practicable, including deciding on the information that will need to be produced (such as board papers) and the processes and procedures that will be undertaken. The Update for Directors further suggests that the

directors should address the evidence to be obtained to support their conclusion and develop, where necessary, any remedial action plan.

10. To help minimise the risk of last minute surprises, the Update for Directors recommends companies have early discussions with their auditor about their plans. It also suggests that it may be useful for a draft of the relevant disclosures about going concern and liquidity risk to be prepared and discussed with the auditor before the end of the financial year. Such discussions may help the auditor plan its audit procedures and minimise the risk of the auditor qualifying its opinion on the grounds of a scope limitation or of a disagreement due to inadequate disclosure. It may also encourage the directors to develop a realistic remedial action plan where one is needed.

11. Notwithstanding early discussions between the company and its auditors both directors and auditors need to take account of subsequent developments as final assessments of going concern need to be made at the date that the directors approve the annual report and accounts taking into account the relevant facts and circumstances at that date.

DEVELOPMENTS IN CORPORATE REPORTING

12. The Update for Directors describes recent developments in corporate reporting relating to:

    (a) the disclosure of the principal risks and uncertainties facing the company in the Business Review to be included in Director's Reports; and

    (b) additional disclosures relating to going concern and liquidity risk arising from changes to IFRS and UK GAAP.

13. The current squeeze on corporate cash-flows means that liquidity risk is likely to be a material risk this year for many more entities. As a consequence a greater number of companies are likely to need to present relevant disclosures concerning liquidity risk[2]. Examining the directors' processes underlying the preparation of these disclosures is likely to provide useful audit evidence for auditors with respect to the validity of the going concern assumption.

PLANNING

14. Risks arising from current economic circumstances are likely to impact a number of different aspects of the financial statements, for example the economic conditions may impact matters such as inventory obsolescence, goodwill impairments and cash flows, which may in turn affect whether the company is a going concern. It is important that

2 For IFRS, disclosures concerning liquidity risk are required by IFRS 7, IAS 1 and IAS 7. For UK GAAP, disclosures are required by FRS 18 and, where applicable, FRS 13 and FRS 29.

auditor judgments on such matters are based on consistent underlying information and views.

15. Because of the significance and pervasive nature of the current economic circumstances auditors need to take account of them at all stages of forthcoming audits and in particular when:

    (a) making risk assessments during the planning process and re-assessing those risks as the audit progresses;

    (b) performing audit procedures to respond to assessed risks;

    (c) evaluating the results of audit procedures (including as part of any engagement quality control review); and

    (d) forming an opinion on the financial statements.

CONSIDERING THE DIRECTORS' ASSESSMENT OF GOING CONCERN

16. ISA (UK and Ireland) 570 requires the auditor to consider the appropriateness of the directors' use of the going concern assumption in the preparation of the financial statements, and consider whether there are material uncertainties about the entity's ability to continue as a going concern that need to be disclosed in the financial statements[3]. In order to meet this requirement the auditor's procedures will comprise:

    (a) evaluating the means by which the directors have satisfied themselves it is appropriate for them to adopt the going concern basis in preparing the financial statements, (see paragraphs 17 to 22);

    (b) concluding whether or not they concur with the directors' view, (see paragraphs 23 to 25);

    (c) assessing whether the financial statements contain adequate disclosures relating to going concern, (see paragraphs 26 to 28);

    (d) determining the implications for the auditor's report on the financial statements (see paragraphs 29 to 40); and

    (e) preparing appropriate documentation (see paragraph 41).

3 Paragraphs 2 and 9 of ISA (UK and Ireland) 570.

EVALUATING HOW THE DIRECTORS HAVE SATISFIED THEMSELVES THAT IT IS APPROPRIATE TO ADOPT THE GOING CONCERN BASIS

17. Audit procedures that are likely to be relevant when evaluating the adequacy of the means by which the directors have satisfied themselves whether it is appropriate for them to adopt the going concern basis in preparing the financial statements include:

    - Analysing and discussing cash flow, profit and other relevant forecasts with management.
    - Reviewing the terms of loan agreements and determining whether any may have been breached.
    - Reading minutes of the meetings of shareholders, those charged with governance and relevant committees for references to financing difficulties.
    - Reviewing events after period end to identify those that may mitigate or otherwise affect the entity's ability to continue as a going concern[4].

18. When analysis of cash flow is a significant factor in considering the future outcome of future events or conditions the auditor considers:

    (a) the reliability of the entity's information system for generating such information; and

    (b) whether there is adequate support for the assumptions underlying the forecast[5].

19. The Update for Directors notes that one impact of current conditions may be to limit finance available from trading counterparties (including suppliers and customers) and providers of finance. Furthermore, lenders may be more risk averse when considering whether to provide or renew finance facilities and may establish new conditions and these conditions may affect the company and its trading counterparties.

20. The Update for Directors indicates that directors will need to consider carefully the position in the light of the information available to them and the assumptions as to the future availability of finance. It:

    (a) notes that in the present economic environment, bankers may be reluctant to provide positive confirmations to the directors that facilities will continue to be available;

    (b) provides a number of examples of understandable reasons for this (see paragraph 37); and

---

4 Additional procedures are described in paragraph 28 of ISA (UK and Ireland) 570.

5 Paragraph 29 of ISA (UK and Ireland) 570.

(c) concludes that the absence of bank confirmation of bank facilities does not, of itself, necessarily cast significant doubt upon the ability of an entity to continue as a going concern.

21. ISA (UK and Ireland) 570 requires that when events or conditions have been identified which may cast significant doubt on the entity's ability to continue as a going concern, the auditor should:

    (a) review the directors' plans for future action based on their going concern assessment;

    (b) gather sufficient appropriate audit evidence to confirm or dispel whether or not a material uncertainty exists through carrying out audit procedures considered necessary, including considering the effect of any plans of the directors and other mitigating factors; and

    (c) seek written representations from the directors regarding their plans for future action[6].

    In general terms, the greater the risks arising from current economic circumstances the more audit evidence will be required.

22. The auditor's procedures necessarily involve a consideration of the entity's ability to continue in operational existence for the foreseeable future. In turn, that necessitates consideration both of the current and the likely future circumstances of the business and the environment in which it operates[7]. The auditor may conclude that it will be appropriate to request from the directors written representations on specific matters relating to their assumptions and plans. Such representations may usefully include confirmation as to the completeness of the information provided to the auditor regarding events and conditions relating to going concern at the date of approval of the financial statements.

CONCLUDING WHETHER OR NOT TO CONCUR WITH THE DIRECTORS' VIEW

23. Assessing the going concern assumption involves making a judgment, at a particular point in time, about the future outcome of events or conditions which are inherently uncertain. Generally, the degree of uncertainty associated with the outcome of an event or condition increases the further into the future a judgment is being made about the outcome of an event or condition. Any judgment about the future is based on available

---

6 Paragraph 26 of ISA (UK and Ireland) 570.

7 Paragraph 9-2 of ISA (UK and Ireland) 570.

evidence and reasonable assumptions about the outcome of the future events made at the time at which the judgment is made.

24. The basis for the auditor's conclusion is the information upon which the directors have based their assessment and their reasoning[8], including, where applicable, advice obtained from external advisers including lawyers. In evaluating the assessment of the directors, the auditor considers the process they followed to make their assessment, the assumptions on which the assessment is based and their plans for future action. The auditor considers whether the assessment has taken into account all relevant information of which the auditor is aware as a result of the audit[9].

25. Where there are events or conditions that cast significant doubt on the ability of the entity to continue as a going concern, the auditor assesses the directors' plans for future action, including plans to liquidate assets, borrow money or restructure debt, reduce or delay expenditures, or increase capital.

ADEQUACY OF DISCLOSURES

26. Developments in accounting standards, including those relating to liquidity risk, together with the current economic conditions can be expected to give rise to a greater number of company annual reports and accounts containing liquidity and going-concern related disclosures.

27. The Update for Directors emphasises the importance, in the current economic conditions, of appropriate disclosures regarding liquidity risk and uncertainties. In its Appendix[10] it provides three illustrative examples of how directors might explain their going concern conclusion in a manner that would facilitate an understanding by readers of annual reports and accounts.

28. The IASB Framework notes that an essential quality of the information provided in financial statements is that it is readily understandable by users[11]. In reviewing the presentation of the disclosures the auditor considers whether the notes to the financial statements taken together with the primary financial statements present a true and fair view. The understandability of the disclosures is an important factor in determining whether the financial statements give a true and fair view.

---

8 Paragraph 18-3 of ISA (UK and Ireland) 570.

9 Paragraph 20 of ISA (UK and Ireland) 570.

10 See page 35 of this Bulletin.

11 In UK GAAP, Chapter 1 of the Statement of Principles for financial reporting states that ''the objective of financial statements is to provide information about the reporting entity's financial performance and position that is useful to a wide range of users for assessing the stewardship of the entity's management and for making economic decisions''.

DETERMINING THE IMPLICATIONS FOR THE AUDITOR'S REPORT

29. ISAs (UK and Ireland) provide for a number of different auditor reports depending upon the specific facts and circumstances[12]. For example, if auditors conclude that the disclosures regarding going concern are not adequate to meet the requirements of accounting standards, including the need for financial statements to give a true and fair view, they are required either to express a qualified or adverse opinion, as appropriate. The report is also required to include specific reference to the fact that there is a material uncertainty that may cast significant doubt about the entity's ability to continue as a going concern[13].

30. If the auditor concludes that a material uncertainty exists that leads to significant doubt about the ability of the entity to continue as a going concern, and those uncertainties have been adequately disclosed in the financial statements, it is required to modify its report by including an emphasis of matter paragraph[14].

31. The current economic circumstances are likely to increase the level of uncertainty existing when the directors make their judgment about the outcome of future events or conditions. However, whilst the effect of current market conditions on individual entities requires careful evaluation, it should not be assumed that the general economic situation at the present time in itself means that a material uncertainty, which casts significant doubt on the ability of the entity to continue as a going concern, exists. Nor are extensive disclosures necessarily indicative of the existence of a significant doubt on the entity's ability to continue as a going concern. Indeed an objective of the disclosures may be to explain why the going concern issues that affect the company do not give rise to a significant doubt.

32. What constitutes a material uncertainty that may cast significant doubt on the entity's ability to continue as a going concern is a judgment involving not only

    (a) the nature and materiality of the events or conditions giving rise to uncertainty; but also:

    (b) the ability of the entity to adopt strategies that mitigate the uncertainty.

---

12 See Appendix 4.

13 Paragraph 34 of ISA (UK and Ireland) 570.

14 Paragraph 31 of ISA (UK and Ireland) 700 requires ***"The auditor should modify the auditor's report by adding a paragraph to highlight a material matter regarding a going concern problem".*** Whereas, ISA (UK and Ireland) 570 uses the term ***"material uncertainty relating to the event or condition that may cast significant doubt on the entity's ability to continue as a going concern".*** The term used in ISA (UK and Ireland) 570 is equivalent to the term ''material matter regarding a going concern problem'' used in ISA (UK and Ireland) 700.

Nature and materiality of the events or conditions

33. Accounting standards do not define what constitutes a ''material uncertainty''. However, determining whether a ''material uncertainty'' exists involves assessing:

    (a) the likelihood of events or conditions occurring; and

    (b) their impact.

    Assessment of these elements may require a high degree of judgment both by the directors and subsequently by the auditors depending upon the individual circumstances of the company and/or group.

34. Examples of possible events or conditions which may give rise to business risks, that individually or collectively may cast significant doubt about the going concern assumption are set out in ISA (UK and Ireland) 570 paragraph 8[15], these include:

    - A net liability or current liability position.
    - Negative operating cash flows.
    - Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment, or excessive reliance on short-term borrowings to finance long-term assets.
    - Major debt repayment falling due where refinancing is necessary to the entity's continued existence.
    - Inability to comply with the terms of loan agreements or to pay creditors on due dates.
    - Loss of a major market, franchise, license or principal supplier.

    A list of other possible events and conditions that may affect the auditor's assessment of going concern are set out in Appendix 2.

35. A factor listed in ISA (UK and Ireland) 570 is that necessary borrowing facilities have not been agreed. In examining borrowing facilities the auditor could decide, for example, that it is necessary:

    (a) to obtain confirmations of the existence and terms of bank facilities; and

    (b) to make its own assessment of the intentions of the bankers relating thereto.

---

15 That paragraph also notes that the existence of one or more of the factors does not always signify that a material uncertainty that casts significant doubt on the entity's ability to continue as a going concern exists.

This latter assessment could involve the auditor examining written evidence or making notes of meetings which it would hold with the directors and, where appropriate, with the directors and the entity's bankers.

36. As discussed in paragraph 20(a), in the present economic environment bankers may be reluctant to confirm to entities or their auditors that facilities will be renewed. This reluctance may extend to companies with a profitable business and relatively small borrowing requirements. The lack of a positive confirmation from a bank does not of itself provide evidence of a material uncertainty that casts significant doubt on the entity's ability to continue as a going concern. Auditors seek to differentiate between circumstances where the lack of a confirmation reflects the existence of a material matter regarding going concern (which, therefore, falls to be emphasised in the auditor's report) and increased caution on the part of bankers that is not indicative of a material matter regarding going concern (and which, therefore, does not fall to be emphasised in the auditor's report).

37. There may be a number of reasons why a bank may be reluctant to confirm that a facility will be available in the future, which would not be a material matter regarding going concern, including:

- The bank responding that in the current economic environment, as a matter of policy, it is not providing such confirmations to its customers or their auditors.
- The entity and its bankers are engaged in negotiations about the terms of a facility (e.g. the interest rate), and where there is no evidence that the bank is reluctant to lend to the company.
- The bank renewed a rolling facility immediately prior to the date of the issuance of the annual report and accounts and is reluctant to go through the administrative burden to confirm that the facility will be renewed on expiry.

38. However, if the auditor concludes that an entity's bankers may be refusing to confirm facilities for reasons that are specific to the entity the auditor considers the significance of this and, where appropriate, discusses with the directors whether there are alternative strategies or sources of financing that would enable the financial statements to be prepared on the going concern basis.

Ability to adopt alternative strategies that mitigate an uncertainty

39. The adverse factors described in paragraph 34 may be mitigated by other favourable factors. For example, the effect of an entity being unable to make its debt repayments from operating cash flows may be counterbalanced by management's plans to maintain adequate cash flows by alternative means, such as by disposal of assets, rescheduling of loan repayments, or obtaining additional capital. Similarly the loss of a principal supplier may be mitigated by the availability of another suitable source of supply. Where an entity

contends that it has alternative strategies to overcome any adverse factors the auditor assesses the effectiveness of such strategies and the ability of management to execute them.

40. If the auditor, in assessing the alternative strategies, considers that they:

(a) are realistic;

(b) have a reasonable expectation of resolving any problems foreseen; and

(c) that the directors are likely to put the strategies into place effectively[16],

the auditor may decide that it is unnecessary to include an emphasis of matter paragraph in the auditor's report[17].

DOCUMENTATION

41. ISA (UK and Ireland) 230 (Revised) ''Audit Documentation'' requires the auditor to prepare audit documentation so as to enable an experienced auditor, having no previous connection with the audit, to understand significant matters arising during the audit and the conclusions reached thereon. Significant matters include, amongst other things, findings that could result in a modification to the auditor's report. With respect to going concern, it is important, therefore, that the auditor documents its knowledge of conditions and events at the date of the auditor's report, and its reasoning with respect to the conclusions it has drawn.

PRELIMINARY ANNOUNCEMENTS

42. While preliminary announcements are no longer mandatory for listed companies, where a preliminary announcement is issued the directors are required by the Listing Rules to have agreed it with the auditor prior to publication.

43. The Listing Rules require that preliminary announcements ''include any significant additional information necessary for the purposes of assessing the results being announced''. An example of such information may be the disclosures that the directors propose to make in the annual report and accounts explaining their rationale for adopting the going concern basis in the annual accounts and setting out the uncertainties that they have considered in making their assessment.

---

16 Paragraph 20-1 of ISA (UK and Ireland) 570.
17 Paragraph 26(b) of ISA (UK and Ireland) 570.

44. Under both the UK and Irish Listing Rules a preliminary announcement is required to give details of the nature of any likely modification that may be contained in the auditor's report on the full financial statements. Under the Listing Rules modified auditor's reports encompass auditor's reports that contain an emphasis of matter paragraph. This would include a paragraph highlighting a material uncertainty relating to an event or condition that may cast significant doubt on the entity's ability to continue as a going concern.

45. Before agreeing to a preliminary announcement, therefore, the auditor assesses

    (a) whether the directors have given adequate prominence to significant additional information concerning going concern[18]; and

    (b) the adequacy of the directors' disclosure, within the announcement, of any likely modification relating to going concern that may be contained in the auditor's report.

REVIEWING INTERIM FINANCIAL INFORMATION

46. International Standard on Review Engagements (ISRE) (UK and Ireland) 2410 ''Review of Interim Financial Information Performed by the Independent Auditor of the Entity'', establishes standards and provides guidance on the auditor's professional responsibilities when the auditor undertakes an engagement to review interim financial information of an audit client and on the form and content of the report.

47. If, as a result of enquiries or other review procedures, a material uncertainty relating to an event or condition comes to the auditor's attention that may cast significant doubt on the entity's ability to continue as a going concern, and adequate disclosure is made in the interim financial information the auditor modifies its review report by adding an emphasis of matter paragraph.

48. However, if a material uncertainty that casts significant doubt about the entity's ability to continue as a going concern is not adequately disclosed in the interim financial information, the auditor is required by ISRE 2410 to express a qualified or adverse conclusion as appropriate. In such circumstances the report is required to include specific reference to the fact that there is such a material uncertainty.

ETHICAL ISSUES

49. The APB's Ethical Standards (ESs) are based on a ''threats and safeguards approach'' whereby auditors identify and assess the circumstances which could adversely affect the auditor's objectivity (''threats''), including any perceived loss of independence, and apply procedures (''safeguards''), which will either eliminate the threat or reduce it to an

---

18 Guidance for auditors on preliminary announcements is set out in Bulletin 2008/2 ''The auditor's association with preliminary announcements made in accordance with the requirements of the UK and Irish Listing Rules''.

acceptable level, that is a level at which it is not probable that a reasonable and informed third party would conclude that the auditor's objectivity is impaired or is likely to be impaired.

50. In the current circumstances, where financial market conditions are difficult and credit facilities may be restricted, auditors need to be particularly alert to the possibility of self-review, management or advocacy threats arising from the provision of non-audit services in relation to a refinancing or restructuring that might jeopardise their objectivity and independence.

51. Examples of engagements that the audit firm may be requested to undertake in the current economic environment and which may give rise to threats to the auditor's independence and objectivity include:

    - Undertaking a review of the business with a view to advising the audited entity on restructuring options.
    - Advising on forecasts or projections, for presentation to lenders and other stakeholders, including assumptions.
    - Advising the audited entity on how to fund its financing requirements, including debt restructuring programmes.

52. When such work is undertaken a threat arises from the risk that the audit team may not review objectively the work undertaken in relation to going concern for audit purposes. Accordingly, where audit firms (and, in particular, members of the audit team) do undertake such engagements, consideration should be given to safeguards such as:

    - A review of the going concern assessment and the conclusion reached by a partner or other senior staff member with appropriate expertise who is not a member of the audit team.
    - Additional procedures undertaken as part of an Engagement Quality Control Review.

53. ES 5 (Revised) states that it is unlikely that safeguards can eliminate a threat or reduce it to an acceptable level:

    (a) in the absence of 'informed management' (paragraph 27 of ES 5 (Revised)) and

    (b) when the non-audit service would require the auditors to act as advocates for the entity in relation to matters that are material to the Financial Statements (paragraph 30 of ES 5 (Revised)).

54. Consequently, where an audit firm is engaged to provide advice to assist an entity it audits to demonstrate that it is a going concern, the audit firm ensures that the entity has

''informed management''[19] capable of taking responsibility for the decisions to be made, thereby reducing the risk that the audit firm may be regarded as taking management decisions for the entity concerned. If the audit firm attends meetings with the entity's bank or other interested parties it takes particular care to avoid assuming responsibility for the entity's proposals or being regarded as negotiating on behalf of the entity or advocating the appropriateness of the proposals such that its independence is compromised.

19 'ES – Provisions Available for Small Entities' provides exemptions relating to informed management for auditors of small entities.

APPENDIX 1

Financial Reporting Council

An Update for Directors of Listed Companies: Going Concern and Liquidity Risk

November 2008

Contents

One – Introduction

1. Current economic conditions provide particular challenges to all involved with annual reports and accounts. One consequence is expected to be an increase in the disclosures in annual reports and accounts about going concern and liquidity risk. As a result the current conditions will present challenges for all of the parties involved:

   - directors will need to ensure that they prepare thoroughly for their assessment of going concern and make appropriate disclosures;
   - auditors will need to ensure that they fully consider going concern assessments and only refer to going concern in their audit reports when appropriate; and
   - investors and lenders will need to be prepared to read all of the relevant information in annual reports and accounts before making decisions.

2. The purpose of this document is to bring together existing guidance in the context of recent developments relating to going concern and liquidity risk disclosures to assist directors, audit committees and finance teams of listed companies during the forthcoming reporting season. It does not establish any new requirements but it does highlight the importance of clear disclosure about going concern and liquidity risk in current economic conditions. This update may also be useful for directors of unlisted companies who have similar responsibilities to assess going concern and make appropriate disclosures.

3. Going concern is a fundamental accounting concept that underlies the preparation of the annual report and accounts of all UK companies. Under both International Financial Reporting Standards (IFRS) and UK Generally Accepted Accounting Principles (UK GAAP) 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 annual report and accounts is issued.

4. Both IFRS and UK GAAP require disclosure of the uncertainties that the directors are aware of in making their assessment of going concern where those uncertainties may cast significant doubt on the group's and company's ability to continue as a going concern.

5. The economic conditions being faced by many companies will necessitate careful consideration by directors when assessing whether it is reasonable for

them to use the going concern basis of accounting, and whether adequate disclosure has been given of going concern risks and other uncertainties. Addressing these challenges well before the preparation of annual reports and accounts may help avoid a last minute problem that might unsettle investors and lenders unnecessarily.

6. Directors will need to 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 to support their conclusion and develop, where necessary, any remedial action plan.

7. Early discussions with company auditors 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 auditors before the end of the financial year.

8. The Financial Reporting Council (FRC) published a consultation document on ''Going concern and financial reporting: proposals to revise the guidance for directors of listed companies'' (the 2008 Consultation) at the beginning of September 2008. Responses to the 2008 Consultation were due on 24 November 2008. The FRC anticipates that an exposure draft will be issued towards the end of the first quarter next year and will not become effective before mid 2009.

9. The FRC would welcome further feedback on the practical challenges of applying the existing guidance ''Going concern and financial reporting: guidance for directors of listed companies registered in the United Kingdom'' (the 1994 Guidance), before the end of February 2009.

10. In the meantime the FRC believes that the existing guidance contained in the 1994 Guidance is fit for purpose even in these times of significant economic stress. This guidance can be found on the FRC website at: *http://www.frc.org.uk/corporate/goingconcern.cfm*.

11. The 1994 Guidance indicates that directors may seek confirmation from their bankers regarding the existence and status of their finance arrangements. In the present economic environment bankers may be reluctant to provide positive confirmation that facilities will continue to be available. The absence of confirmations of bank facilities does not of itself necessarily cast significant doubt upon the ability of an entity to continue as a going concern nor necessarily require auditors to refer to going concern in their reports.

12. The effect of current market conditions on individual entities requires careful evaluation. The general economic situation at the present time does not of itself necessarily mean that a material uncertainty exists about a company's ability to continue as a going concern. However, it is important that annual accounts contain appropriate disclosure of liquidity risk and uncertainties such as are necessary in order to give a true and fair view.

13. Examples illustrating how directors might explain their going concern conclusion taking account of current economic conditions which would facilitate an understanding by readers of annual reports and accounts are included in the appendix to this update.

14. The FRC has recently conducted a study of going concern and liquidity risk disclosures made by companies applying IFRS 7 (Financial instruments: Disclosures) in December 2007 and March 2008 year end annual reports and accounts. The study concluded that there are significant opportunities for improvement by way of better, rather than more, disclosure. In particular, it noted that there was often a significant lack of clarity about how liquidity risk is managed in practice and that much of the relevant information was distributed amongst different parts of annual reports, making it difficult for users to appreciate the full picture.

Two – Accounting requirements with respect to going concern

15. Going concern is a fundamental accounting concept that underlies the preparation of financial statements of all UK companies.

16. Preparing financial statements on a going concern basis is not compatible with the intention or the necessity of a company:

    - entering into a scheme of arrangement with the company's creditors;
    - making an application for an administration order; or
    - being placed into administrative receivership or liquidation.

Assessment of going concern

17. International Accounting Standard (IAS) 1 (Presentation of financial statements) and UK Financial Reporting Standard (FRS) 18 (Accounting policies) require management/directors to make an assessment of an entity's ability to continue as a going concern when preparing financial statements. IAS 1.25 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. 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.''[20]

18. For financial reporting purposes, the assessment of going concern is made at the date that the directors approve the annual report and accounts and takes into account the relevant facts and circumstances at that date. IAS 1.26 also notes that the degree of consideration that may need to be given to the going concern assessment will depend upon the facts of each case.

19. The Listing Rules of the Financial Services Authority also 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, that has been prepared in accordance with the 1994 Guidance.

---

20 Similar provision is made by FRS 18 paragraphs 21-25.

20. The Directors statement on going concern is required to be prepared in accordance with the 1994 Guidance which outlines procedures that the directors may wish to adopt in making their assessment. The 1994 Guidance addresses both annual and interim accounts. In relation to the latter directors of listed companies will also need to consider the requirements of IAS 34 (Interim financial reporting).

21. The procedures that are necessary for the directors to comply with the requirements of IAS 1 or FRS 18 are likely to be similar to those adopted to meet their obligations under the Listing Rules. The 1994 Guidance places particular emphasis on the importance of the processes and procedures that directors carry out and highlights some major areas in which procedures are likely to be appropriate, including:

    - forecasts and budgets;
    - borrowing requirements;
    - liability management;
    - contingent liabilities;
    - products and markets;
    - financial risk management;
    - other factors; and
    - financial adaptability.

22. The 1994 Guidance notes that this list is not exhaustive and the significance of factors will vary from company to company. In the current economic climate many of these factors will have increased in significance which will require directors to consider them with more rigour and formality.

23. In forming their conclusion on going concern directors will need to evaluate which of three potential outcomes is appropriate to the specific circumstances of the group and company. The directors may conclude:

    - there are no material uncertainties that lead to significant doubt upon the entity's ability to continue as a going concern;
    - there are material uncertainties that lead to significant doubt upon the entity's ability to continue as a going concern; or
    - the use of the going concern basis is not appropriate.

24. In addition to the assessment that must be made by directors, auditors are required by auditing standards to determine if, in the auditors' judgment, a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern.

25. Auditing standards provide for a number of different audit reports depending upon the specific facts and circumstances. Auditors may conclude that it is necessary to qualify their opinion, disclaim an opinion, issue an adverse opinion or modify their report by including an emphasis of matter paragraph.

26. Auditors are required to consider the disclosures about going concern and liquidity risk made in the financial statements. If auditors conclude that the disclosures are not adequate to meet the requirements of accounting standards, 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. If auditors conclude that a material uncertainty exists that leads to significant doubt about the ability of the entity to continue as a going concern, and those uncertainties have been adequately disclosed in the financial statements, they are required to modify their report by including an emphasis of matter paragraph.

27. The combination of these requirements will generally result in one of the following three outcomes:

Outcome	**Consequence for the directors' statement on going concern**	**Consequence for the auditors' report**
No material uncertainties leading to significant doubt about going concern have been identified by the directors.	Disclosure explaining the conclusion on going concern and how that has been reached. ***Examples 1 and 2 in the attached appendix illustrate this outcome.***	Unmodified report (clean) – provided the auditors concur with the directors' assessment and supporting disclosures.
Material uncertainties leading to significant doubt about going concern have been identified by the directors.	Disclosures explaining the specific nature of the material uncertainties and explaining why the going concern basis has still been adopted. ***Example 3 in the attached appendix illustrates this outcome.***	Modified report including an emphasis of matter paragraph highlighting the existence of material uncertainties – provided auditors concur with the directors' assessment and supporting disclosures.

The directors conclude that the going concern basis is not appropriate.	Disclosures explaining the basis of the conclusion and the accounting policies applied in drawing up financial statements on a non-going concern basis.	Unmodified report (clean) – provided that the accounts contain the necessary disclosures and the auditors consider the basis to be appropriate to the specific facts and circumstances.

28. The 1994 Guidance also provides for disclosure when directors conclude that the going concern basis should be used despite having identified factors which cast doubt on the ability of the company to continue in existence for the foreseeable future. Significant changes to disclosure requirements about risks and uncertainties in IFRS, UK GAAP and the Companies Act 2006 (the Act) since 1994 may mean that sufficient disclosure of the factors giving rise to the problem will have been provided through these disclosures (see paragraphs 40 to 49).

29. One impact of current conditions may be to limit finance available from trading counterparties including suppliers, customers and providers of finance. Furthermore, lenders may be more risk averse when considering whether to provide or renew finance facilities and may establish new conditions and these conditions may affect the company and the group and their trading counterparties.

30. In relation to bank and other facilities, paragraphs 30 to 32 of the 1994 Guidance may assist:

> 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.*
>
> 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.*
>
> 32. *The directors may seek confirmation from their bankers regarding the existence and status of any finance arrangements which the company has entered into.*

31. Directors will need to consider carefully the position in the light of the information available to them and the assumptions as to the future availability of finance. Accounting standards do not define what constitutes a 'material uncertainty that may cast significant doubt upon the entity's ability to continue as a going concern'. This involves assessing both the probability of an event occurring and the impact it will have if it does occur. Assessment of these elements may require a high degree of judgment both by the directors, and subsequently by the auditors depending upon individual company and group circumstances.

32. In the present economic environment bankers may be reluctant to provide positive confirmations 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 bank may be reluctant to confirm that a facility will be available in the future including:

    - the bank responding that in the current economic environment, as a matter of policy, it is not providing such confirmations to its customers;
    - the entity and its bankers are engaged in negotiations about the terms of a facility (e.g. the interest rate), however there is no evidence that the bank is reluctant to lend to the company; and
    - the bank renewed a rolling facility immediately prior to the date of the issuance of the annual report and accounts and is reluctant to go through the administrative burden to confirm that the facility will be renewed again in a year's time.

33. The absence of confirmations of bank facilities does not of itself necessarily cast significant doubt upon the ability of an entity to continue as a going concern nor require necessarily auditors to refer to going concern in their reports.

Three – Going concern review period

34. IFRS contains specific requirements about the period which directors are required to review when assessing going concern. IAS 1.26 provides that management should take 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.

35. FRS 18 requires disclosure if the period considered by the directors is less than twelve months from the date of approval of the financial statements.

36. Directors should consider the 1994 Guidance which provides that budgets and forecasts should be prepared to cover the period to the next balance sheet date as a minimum and notes that further periods are generally covered by medium or long-term plans which give an indication in general terms of how the directors expect the company to fare. The guidance also notes that the assessment is based on what is known to the directors at the date on which they approve the annual report and accounts which includes events or circumstances of which they are aware that arise after the end of the review period.

37. Where the period considered by the directors has been limited, for example, to a period of less than twelve months from the date of the approval of the annual report and accounts, the directors need to consider whether additional disclosures are necessary to explain adequately the assumptions that underlie the adoption of the going concern basis.

38. Auditing standards also address going concern and the period of the review by the directors. Auditors have an explicit obligation to include an extra paragraph in their audit report if the period covered by the directors' review is less than twelve months from the date of approval of the annual report and accounts and this fact is not disclosed by the directors.

Four – Insolvency

39. Doubts upon the ability of a company to remain 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. Where the directors are unable to state that the going concern basis is appropriate, they should consider taking professional advice.

Five – Disclosures relevant to going concern and liquidity risk

Disclosure requirements of the Listing Rules about going concern

40. The Listing Rules 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.

41. The 1994 Guidance notes that if there are doubts as to the appropriateness of the going concern presumption then the annual accounts may need to reflect any relevant factors in greater detail if they are to show a true and fair view. The guidance also notes that when there are factors which, in the event of an unfavourable outcome, cast doubt on the appropriateness of the going concern presumption, 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.

Disclosure requirements of IFRS and UK GAAP about going concern and liquidity risk

42. IAS 1 and FRS 18 have explicit disclosure requirements in the event that the directors conclude that there are material uncertainties that may cast significant doubt upon the entity's ability to continue as a going concern. In addition, in recent years there have also been significant changes to specific accounting standards that are relevant to disclosures about liquidity risk and other risks and uncertainties including:

Requirement	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
Estimating future cash flows (in connection with impairment of intangible assets).	IAS 36 paragraphs 33 to 54	FRS 11 paragraphs 36 to 40
Disclosure of undrawn borrowing facilities and any restrictions such as covenant requirements, where relevant.	IAS 7 paragraph 50 (a)	No explicit requirement
Disclosure of defaults and covenant breaches and potential reclassification of loans in default as current liabilities.	IAS 1 paragraphs 74 to 76	No explicit requirement

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

IFRS liquidity risk disclosures

43. Liquidity risk is the risk that an entity will encounter difficulty in meeting its obligations associated with financial liabilities. IFRS 7 (FRS 29) requires an entity to make both qualitative and quantitative disclosures concerning liquidity risk, where it is a material financial risk.

44. Where liquidity risk is material, IFRS 7 (FRS 29) requires:

- 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.

45. 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.

46. The current squeeze on corporate cash flows means that liquidity risk is likely to be a material risk this year for many more entities. As a consequence, a greater number of companies are likely to need to present relevant disclosures as required by IFRS 7 (FRS 29), IAS 1, IAS 7 and FRS 18.

Disclosure requirements of the Companies Act 2006 related to Directors' Reports

47. The Act requires the Directors' Report of all companies (except companies subject to the small companies' regime) to include a Business Review.

48. The Business Review is required to be a balanced and comprehensive analysis of the development and performance of the business of the company 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 should include a description of the principal risks and uncertainties facing the company.

49. 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 which are essential to the business of the company.

50. Directors will need to explain in the Business Review the principal risks and uncertainties facing the company arising from the current difficult economic conditions. 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 ;
- risks arising from current credit arrangements (including the availability of insurance where relevant) with either customers or suppliers;
- a dependency on key suppliers and customers ; and
- uncertainties posed by the potential impact of the economic outlook on business activities.

51. The Act also requires auditors 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. Auditing standards provide guidance for auditors on how they should carry out this work.

FRC review of going concern and liquidity risk disclosures

52. The FRC has published a study into going concern and liquidity risk disclosures in the financial statements of listed companies that have adopted IFRS 7. The study can be obtained from the FRC *http://www.frc.org.uk/corporate/goingconcern.cfm*. The study notes that information about going concern and

liquidity risk was distributed amongst a number of different parts of the annual report and accounts reviewed, thus making it difficult for users to determine and evaluate the extent to which liquidity concerns were relevant to the business and how liquidity risk was being managed in practice.

53. 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 reports and accounts.

54. If it is not practical to provide the information in a single section, the study recommends that the key disclosures be brought together by way of a note including cross references to help readers of annual reports and accounts to find all of the relevant pieces of information.

55. It would be useful if such a note included the following components:

- Paragraph 1 explaining cash and borrowing positions and how liquidity risk is managed in practice.
- Paragraph 2 explaining whether confirmation of the renewal of banking and other facilities has been sought and if so whether those confirmations have been obtained[21].
- Paragraph 3 stating that the use of the going concern basis of accounting is appropriate and explaining the basis of that conclusion.

56. Examples illustrating these disclosures are included in the appendix to this update.

57. The FRC study also concluded that, while in general information about cash balances, borrowings and facilities was provided on a comprehensive basis, the level of detail about how liquidity risk was managed in practice and the information used by key management to monitor liquidity risk varied greatly. In particular:

- For many companies, the disclosures were generic rather than specific in nature. Only a minority of companies provided information that shed light on how the business managed its day to day cash flow and borrowing levels.
- A conclusion could not be reached on whether appropriate disclosure had been made of summarised data about liquidity risk as provided to key

21 See paragraphs 29 to 33.

management personnel (generally the directors). Reaching such a conclusion would have required access to internal company documentation.

Six – Preliminary announcements

58. Preliminary announcements of annual results form one of the focal points for investor interest, primarily because they confirm or update market expectations. Under the Listing Rules such announcements are voluntary, although if made their contents are subject to minimum requirements. Where a company chooses to publish a preliminary announcement the directors are required by the Listing Rules to have agreed the preliminary announcement with their auditor prior to publication.

59. The Listing Rules provide that, if a preliminary announcement is made, it should give details of the nature of any likely modification that may be contained in the auditor's report required to be included with the annual report and accounts. Modified audit reports encompass audit 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).

Appendix – examples of going concern disclosures

The purpose of this appendix is merely to illustrate the principles in paragraph 55 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 significant positive bank balances, uncomplicated circumstances and little or no exposure to uncertainties in the current economic environment which 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 accounts.

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

Paragraph similar to example 1, paragraph 1.

As highlighted in note B to the financial statements, the group meets its day to day working capital requirements through an overdraft facility which 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.

Paragraph as per example 1, paragraph 3.

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

Paragraph as example 1, paragraph 1.

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's 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 accounts.

APPENDIX 2

EVENTS OR CONDITIONS THAT MAY AFFECT GOING CONCERN

Possible events and conditions that may affect the auditor's assessment of going concern are listed below:

- Obtaining external finance:
  - Entity has experienced difficulties in the past in obtaining external finance facilities and/or complying with the related terms and covenants.
  - Borrowing agreements or executory contracts include clauses relating to debt covenants or subjective clauses (e.g. a ''material adverse change clause'') that trigger repayment.
  - Entity has breached some of the terms or covenants giving rise to the risk that the facilities may be withdrawn or not renewed.
  - Finance facilities are due for renewal in the next year.
  - Management have no plans for alternative arrangements should current facilities not be extended.
  - Finance facility is secured on assets (e.g. properties) that have decreased in value below the amount of the facility.
  - There are significant doubts about the financial strength of the entity's bankers.
  - Financing is provided by a syndicate of banks and other financial institutions and there are concerns about the viability of one or more of the members of the syndicate.
- Management plans to overcome financing difficulties include disposal of assets or possible rights issues:
  - Plans developed prior to current market conditions have not been updated or stress tested.
  - Lack of evidence that management can realise the assets at the values arising from planned disposals or obtain the support of shareholders in relation to a rights issue.
- Entity provides significant loans or guarantees:
  - Guarantees that may be called in.
  - Borrowers who may be unable to make payments.
- Entity dependent on guarantees provided by another party:
  - Guarantor no longer able/prepared to provide the guarantee.

- Future cash flows:
  - Reduction in cash flows resulting from unfavourable economic conditions.
  - Customers taking longer/unable to pay.
  - Terms or covenants of renewed financing are changed and become more difficult to comply with (e.g. increased interest rates or charges).
  - Entity is subject to margin calls as a result of a decrease in fair market value of financial instruments that it holds.
  - Entities have issued loans (or received borrowings) having an introductory period during which favourable terms are in force which revert to normal market rates in the forthcoming year.
- Entity heavily dependent on counterparties such as suppliers and customers:
  - Suppliers facing financial difficulties provide essential goods/services.
  - Entity unable to find alternative suppliers.

APPENDIX 3

RISK FACTORS ARISING FROM CURRENT ECONOMIC CONDITIONS

This Appendix identifies some factors that may increase the risk of material misstatement in financial statements during the current economic conditions, other than in relation to going concern.

Fair Values:

- Entity needs to change valuation model and/or management's assumptions to reflect current market conditions.
- Active market no longer exists, requiring use of a model for valuation purposes.
- Inputs to a model are not based on observable market inputs but rather are based on the entity's own data.
- Impairment of non-financial assets held at fair value (e.g. properties).
- Suspension of external valuation indices triggering a need for alternative valuation approaches.
- Entity uses an external pricing service for fair value measurements that needs to change its valuation model and/or assumptions to reflect current market conditions.
- Entity does not have necessary expertise to undertake valuations.
- Recent amendments to GAAP (IAS 39, IFRS 7, FRS 26 and FRS 29) may require or permit the reclassification of certain financial assets.

Impairments:

- Impairments of assets other than those held at fair value (e.g. need for increased doubtful debt provisions because previously reliable customers may not be able to pay their debts when due).
- Stock obsolescence resulting from significant decreases in demand for certain types of product.
- Impairment of the carrying amount of purchased goodwill.
- Increasing discount rates used in impairment calculations because capital has become more expensive.
- Effect on impairment calculations of subsequent events, in particular those relating to counterparties.
- Current credit market conditions may lead to the triggering of acceleration clauses which may lead to the impairment of financial assets.

Current versus non-current classification:

- Current market conditions may bring into question the classification of assets and liabilities as current or non-current. (For example the re-classification of liabilities as a result of a breach of loan covenants).

Revenue Recognition:

- Current credit market conditions may make it more difficult to demonstrate that the revenue recognition criteria, in (IAS 18/FRS 5) have been met.

Pensions:

- Pension obligations of an entity increased by reduction in value of assets in a related defined benefits pension scheme.
- Effect of illiquid investments and decreases in expected rates of return on investments.

Hedging:

- Hedging arrangements no longer effective when a derivative counterparty is experiencing financial difficulty or, more generally due to widening credit spreads on the derivative counterparty.
- In current market conditions, hedge effectiveness may have failed for the current period either because it is no longer probable that a derivative counterparty will meet its obligations, or because counterparty credit spreads have increased substantially, or because of the effect of changes in inter-bank lending rates on fair value interest rate hedges.

Insurance:

- The ability of an insurance company providing credit insurance to meet claims.

Deferred income taxes:

- If a company is reporting losses or is exposed to future losses there may be a need for a valuation allowance for deferred tax assets.

APPENDIX 4

EXAMPLES OF CONCLUSIONS THE AUDITOR MIGHT DRAW

Auditor's report	***Circumstances***	***Example modified audit reports***[22]
	Auditor agrees with the directors' assessment	
Clean	Preparing the financial statements on the going concern basis is appropriate, the going concern and liquidity disclosures are adequate and there are no material uncertainties that cast significant doubt on the entity's ability to continue as a going concern. (See examples 1 and 2 in the appendix to the Update for Directors)	n/a
Modified by inclusion of emphasis of matter paragraph[23]	Preparing the financial statements on the going concern basis is appropriate but there are material uncertainties described in the financial statements that cast significant doubt on the entity's ability to continue as a going concern. (See example 3 in the appendix to the Update for Directors)	Example 1
	Auditor disagrees with the directors' assessment	
Qualified opinion	Preparing the financial statements on the going concern basis is appropriate but there are material uncertainties that cast significant doubt on the entity's ability to continue as a going concern that are not adequately described in the financial statements	Example 5
Adverse opinion	The financial statements have been prepared on the going concern basis but the auditor has concluded that using the going concern basis is inappropriate.	–

22 References are to the examples in Appendix 3 to Bulletin 2006/6 'Auditor's Reports on Financial Statements in the United Kingdom'

23 ISA (UK and Ireland) 700 Paragraph 34 notes that in extreme cases, such as situations involving multiple uncertainties that are significant to the financial statements, the auditor may consider it appropriate to express a disclaimer of opinion.

Auditor's report	***Circumstances***	***Example modified audit reports***
	<u>The directors refuse to undertake, or extend, an assessment of going concern</u>	
Disclaimer of opinion	Where the directors' refusal either to undertake or to extend an assessment of going concern results in the auditor being unable to form an opinion on whether the financial statements give a true and fair view as the scope of the audit has been limited because the directors' consideration of going concern is completely inadequate.	Example 7

In all cases, if the period used by the directors in making their assessment of going concern is less than one year from the date of approval of the financial statements, and they have not disclosed that fact in the financial statements, the auditor is required by paragraph 31-4 of ISA (UK and Ireland) 570 to do so within the auditor's report.

NOTICE TO READERS

The APB is part of the Financial Reporting Council Limited a company limited by guarantee.
Registered in England number 2486368.Registered Office: 5th Floor, Aldwych House,
71-91 Aldwych, London WC2B 4HN

ISBN 978-1-84798-136-3

9 781847 981363

CODE: UP/APBD-BI8227

Further copies, £8.00, post-free, can be obtained from:

FRC Publications
145 London Road
Kingston upon Thames
Surrey
KT2 6SR

Telephone: 020 8247 1264
Fax: 020 8247 1124
E-mail: customerservices@cch.co.uk
or ordered online at: www.frcpublications.com