Financial Reporting Council

October 2015

Exposure Draft: Guidance on the Going Concern Basis of Accounting and Reporting on Solvency and Liquidity Risks

Guidance for companies that do not apply the UK Corporate Governance Code

The FRC is responsible for promoting high quality corporate governance and reporting to foster investment. We set the UK Corporate Governance and Stewardship Codes as well as UK standards for accounting, auditing and actuarial work. We represent UK interests in international standard-setting. We also monitor and take action to promote the quality of corporate reporting and auditing. We operate independent disciplinary arrangements for accountants and actuaries, and oversee the regulatory activities of the accountancy and actuarial professional bodies.

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Contents

Summary

i. The Financial Reporting Council's mission is to promote high quality corporate governance and reporting to foster investment. Ensuring that a business is able to continue over the longer term involves an assessment of the risks that could threaten a company's future viability, including solvency risk and liquidity risk. Companies must also assess whether the going concern basis of accounting is appropriate. The process should inform clear and concise financial reporting disclosures that enable investors to understand a company's exposure to these risks.

Background

ii. In June 2012, the Panel of the Sharman Inquiry published its Final Report and Recommendations[1] on Going Concern and Liquidity Risk. The key elements of the recommendations from the Panel included, amongst other things:

- clarification of the accounting and stewardship purposes of the going concern assessment and disclosure process and the related thresholds for such disclosures;
- a review of the 2009 Guidance for Directors ('2009 Guidance') to ensure that the going concern assessment is integrated with the directors' business planning and risk management processes and includes a focus on both solvency and liquidity risks, considering the possible impacts on the business over the longer term; and
- encouraging companies to move away from a model where disclosures about going concern risks are only highlighted when there are significant doubts about a company's survival.

iii. Since that time, the FRC published two consultation papers seeking views on the implementation of the Sharman recommendations.

iv. For those companies within the scope of the UK Corporate Governance Code (the 'Code'), the FRC decided to take forward the implementation of the recommendations of the Sharman Panel as part of its September 2014 update to the Code. It also published supporting *Guidance on Risk Management, Internal Control and Related Financial and Business Reporting*.[2]

v. In response to the feedback received, the FRC noted that it would issue separate, simplified guidance for companies that do not apply the Code.

vi. The FRC is also currently consulting[3] on whether to enhance auditor reporting for all entities such that where the auditor has concluded that the use of the going concern basis of accounting is appropriate and no material uncertainty has been identified, the auditor reports by exception on these matters in the auditor's report.

Aims of the guidance

vii. The FRC has developed [draft] guidance that aims to:

- be proportionate for non-Code companies; and
- reflect developments in the FRC's thinking as a consequence of the Sharman Inquiry.

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[1] A copy of the report is available at https://www.frc.org.uk/getattachment/591a5e2a-35d7-4470-a46c-30c0d8ca2a14/Sharman-Inquiry-Final-Report.aspx.

[2] A copy of the guidance is available at https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Guidance-on-Risk-Management,-Internal-Control-and.pdf

[3] A copy of the consultation is available at https://frc.org.uk/Our-Work/Publications/FRC-Board/Consultation-Enhancing-Confidence-in-Audit.aspx

viii. This [draft] guidance replaces the FRC's *Going Concern and Liquidity Risk: Guidance for Directors of UK Companies 2009* and *An Update for Directors of Companies that Adopt the Financial Reporting Standard for Smaller Entities (FRSSE): Going Concern and Financial Reporting.*

ix. This [draft] guidance incorporates recent developments in the corporate reporting framework, most notably the introduction of new UK and Ireland GAAP and the strategic report.

Invitation to comment

1. The FRC is requesting comments by 15 January 2016. The FRC is committed to developing guidance and standards based on evidence from consultation with users, preparers and others. Comments are invited on all aspects of the proposals. In particular, comments are sought on the questions below.

2. Comments are most helpful if they indicate the specific paragraph or groups of paragraphs to which they relate, contain clear rationale and, where applicable, suggest an alternative approach or text.

Scope

3. The draft guidance is best practice for all companies except those that are small and those that are required or choose voluntarily to apply the UK Corporate Governance Code.

Question 1

Do you agree with the scope of the guidance as set out in section 1?

Question 2

Is the guidance sufficient for the different types of company that fall within its scope?

Solvency and liquidity risks

4. The draft guidance encourages directors to think broadly about risks and uncertainties that could threaten the company's development, performance, position and future prospects, including solvency and liquidity risk.

Question 3

Do you agree with the draft guidance on the assessment of solvency and liquidity risk as set out in paragraphs 4.1 to 4.6?

Linkage

5. Reporting on the going concern basis of accounting, material uncertainties and principal risks and uncertainties are distinct but linked concepts.

Question 4

Does the draft guidance sufficiently distinguish between the assessment of and reporting on the 'narrow' going concern basis of accounting (section 3) and the broader concept of solvency risk and liquidity risk (section 4)?

Question 5

Does the draft guidance adequately highlight the relationships between the concepts (section 2)?

Practical application

6. One of the objectives of the draft guidance is to ensure that it serves as a practical guide.

Question 6

Do you consider that the guidance is sufficiently practical? If not, how might the guidance be improved?

[Draft] Guidance on the Going Concern Basis of Accounting and Reporting on Solvency and Liquidity Risks

Guidance for companies that do not apply the UK Corporate Governance Code

1 Introduction and scope

1.1 The purpose of this [draft] guidance is to bring together the requirements of company law, accounting standards, auditing standards, other regulation and existing FRC guidance relating to reporting on the going concern basis of accounting, solvency risk and liquidity risk.

1.2 This [draft] guidance is designed to be non-mandatory, best practice guidance for all companies[4] required to make disclosures on the going concern basis of accounting in their financial statements and on principal risks and uncertainties within their strategic report, except those that are required or choose voluntarily to apply the UK Corporate Governance Code.[5]

1.3 Although this [draft] guidance is not primarily directed to small and micro-companies there may be some aspects that are of relevance, taking into consideration that:

- small and micro-companies are not required to prepare a strategic report;
- micro-companies applying FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime* are not required to provide any disclosures on the going concern basis of accounting, as their financial statements are presumed, in law, to give a true and fair view if the minimal legal disclosure requirements are met; and
- small companies applying Section 1A Small Entities of FRS 102 *The Financial Reporting Standard applicable in the UK and the Republic of Ireland* are not required to provide disclosures on the going concern basis of accounting, although their directors are encouraged to provide such disclosures, where appropriate, in meeting their responsibility to prepare financial statements that give a true and fair view.

1.4 However, small and micro-companies must assess whether the going concern basis of accounting is appropriate in preparing their financial statements. Following that assessment, in some circumstances small companies may need to provide additional disclosures for the financial statements to give a true and fair view. Therefore, such companies may still find this guidance useful taking into consideration the company's size, complexity, the particular circumstances and the regulatory requirements that are applicable. Paragraphs 3.1 to 3.12 cover the assessment of the going concern basis of accounting and may be particularly relevant.

1.5 The [draft] guidance is intended to serve as a practical guide for directors. It includes:

- factors to consider when determining whether the going concern basis of accounting is appropriate and making assessments of solvency risk and liquidity risk relevant to a company's future viability;
- guidance on the assessment periods for the going concern basis of accounting and risks; and
- a summary of the reporting requirements.

1.6 Viability refers to the ability of a company to continue in operation and meet its liabilities as they fall due over the period of the assessment.

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[4] For simplicity, this guidance uses the terms 'director' and 'company'. However, the guidance is also likely to be relevant to other entities.

[5] Companies applying the UK Corporate Governance Code should refer to the FRC Guidance on Risk Management, Internal Control and Related Financial and Business Reporting available on the FRC website. More complex and other publicly traded entities that are not required to apply the UK Corporate Governance Code may also wish to refer to this as an alternative source of guidance.

1.7 Liquidity risk is the risk that a company will be unable to meet its liabilities as they fall due. A company must generate and retain sufficient cash to allow it to meet its liabilities at the time contractual payments are due. The viability of an otherwise profitable company can be threatened if it is incapable of converting assets into cash when it is necessary to make such payments.

1.8 Solvency risk is the risk that a company will be unable to meet its liabilities in full. Over the long term a company must generate sufficient value such that its assets exceed its liabilities. A failure to do so could render it insolvent and threaten its viability.

1.9 The main principles are set out in bold text followed by supporting application guidance.

1.10 This [draft] guidance:

- encourages directors to take a broader view, over the longer term, considering risks and uncertainties that go beyond the specific requirements in accounting standards;
- acknowledges that companies will have risk management and control processes in place that will underpin the assessment but that the degree of formality of this process will depend on the size, complexity and the particular circumstances of the company; and
- uses the term ‘going concern’ only in the context of referring to the going concern basis of accounting for the preparation of financial statements, as defined in accounting standards.

2 Overview of requirements

2.1 This [draft] guidance considers the related legal requirements for disclosures in the strategic report on principal risks and uncertainties and the requirements of accounting standards for disclosures in the financial statements on the going concern basis of accounting.

The going concern basis of accounting

2.2 All companies are required to adopt the going concern basis of accounting when preparing their financial statements, except in circumstances where directors intend to liquidate the entity or to cease trading, or have no realistic alternative to liquidation or cessation of operations. Therefore, directors must assess whether there are circumstances that would make adoption of the going concern basis of accounting inappropriate.

2.3 FRS 102 and IAS 1 *Presentation of Financial Statements* require disclosure when a company does not prepare financial statements on a going concern basis and when there are material uncertainties related to events or conditions that cast significant doubt upon the company's ability to continue to adopt the going concern basis of accounting.

Risks and uncertainties

2.4 A company faces many risks. However, only the principal risks are required to be disclosed in the strategic report. Of these, some may potentially threaten the future viability of the company, because of their impact on liquidity and solvency or due to other significant operational impacts. Some may be so significant that they highlight material uncertainties that may cast significant doubt on a company's ability to adopt the going concern basis of accounting in the future; these material uncertainties will then be disclosed in accordance with the requirements of accounting standards. In extreme circumstances, such risks may crystallise thus making liquidation of the company inevitable and the going concern basis of accounting inappropriate. See figure 1 below.

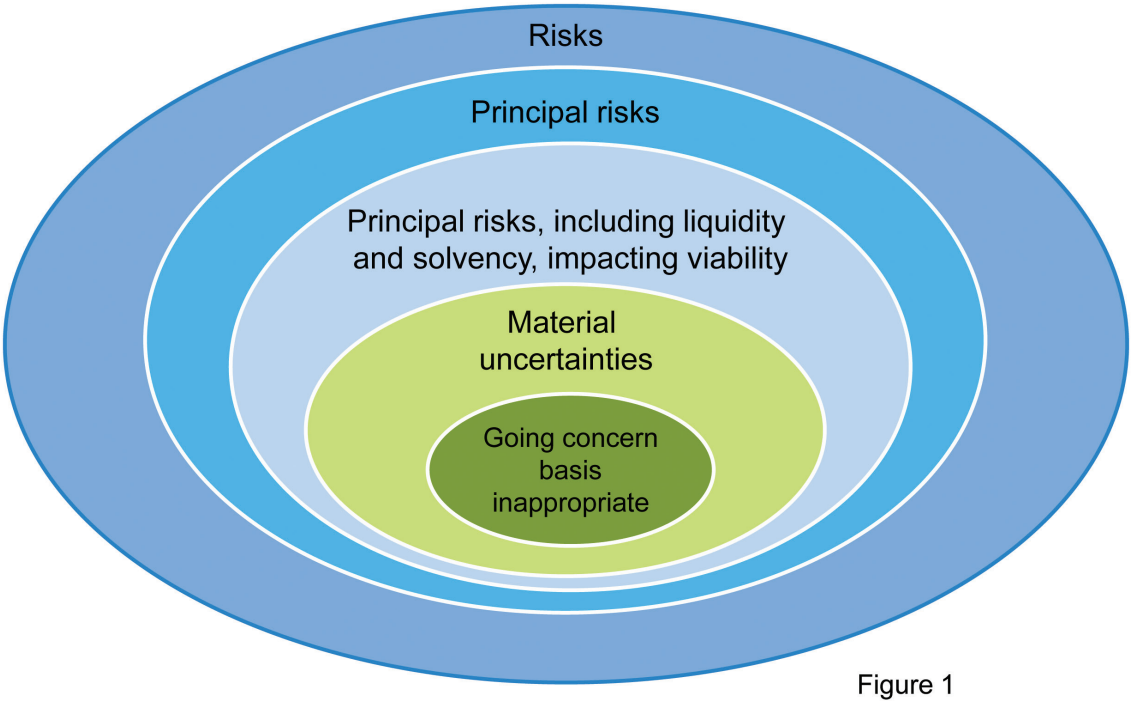

Figure 1

2.5 The process for determining which disclosures are necessary in any given situation includes:

- identification of risks and uncertainties, including those relating to solvency and liquidity and other potential threats to future viability;
- determining, through the application of materiality, which of the identified risks are 'principal' risks and thereby require disclosure in the strategic report;
- considering whether additional disclosures are necessary for the financial statements to provide a true and fair view;
- considering whether there are material uncertainties that require disclosure in accordance with accounting standards; and
- in extreme circumstances, considering whether it is inappropriate to adopt the going concern basis of accounting.

3 Going concern basis of accounting and material uncertainties

Small and micro-companies may find paragraphs 3.1–3.12 useful when assessing whether the going concern basis of accounting is appropriate.

Assessment

3.1 **Directors should assess whether the adoption of the going concern basis of accounting when preparing the financial statements is appropriate. The assessment process carried out by the directors should be proportionate to the size, complexity and the particular circumstances of the company.**

Adoption of going concern basis of accounting

3.2 Companies are required to adopt the going concern basis of accounting, except in circumstances where management intends to liquidate the entity or to cease trading, or has no realistic alternative to liquidation or cessation of operations.

3.3 Accordingly, the threshold for departing from the going concern basis of accounting is a very high hurdle, as there are often realistic alternatives to liquidation or cessation of trade. This will even be the case when material uncertainties related to events or conditions that may cast significant doubt upon the company's ability to continue as a going concern have been identified.

3.4 The assessment of going concern should take into account the relevant facts and circumstances at the date of approval of the financial statements. Any judgement made previously, whilst reasonable at the time, can be overturned by subsequent events. The assessment should be documented in sufficient detail to explain the basis of the directors' conclusion with respect to the going concern basis of accounting at the date of approval of the financial statements.

Material uncertainties

3.5 Accounting standards also require directors to make an assessment of a company's ability to continue to adopt the going concern basis of accounting in the future. In performing this assessment, the directors should consider all available information about the future, the realistically possible outcomes of events and changes in conditions and the realistically possible responses to such events and conditions that would be available to the directors.

3.6 Events or conditions might result in the use of the going concern basis of accounting being inappropriate in future reporting periods. As part of their assessment, the directors should determine if there are any material uncertainties relating to events or conditions that may cast significant doubt upon the continuing use of the going concern basis of accounting in future periods.

3.7 Uncertainties relating to such events or conditions should be considered material, and therefore disclosed, if their disclosure could reasonably be expected to affect the economic decisions of shareholders and other users of the financial statements. This is a matter of judgement. In making this judgement, the directors should consider the uncertainties arising from their assessment, both individually and in combination with others.

3.8 In determining whether there are material uncertainties, the directors should consider:

- the magnitude of the potential impacts of the uncertain future events or changes in conditions on the company and the likelihood of their occurrence;
- the realistic availability and likely effectiveness of actions that the directors could take to avoid, or reduce the impact or likelihood of, the uncertain future events or changes in conditions; and
- whether the uncertain future events or changes in conditions are unusual, rather than occurring with sufficient regularity for the directors to make predictions about them with a high degree of confidence.

3.9 Uncertainties should not usually be considered material if the likelihood that the company will not be able to continue to use the going concern basis of accounting is assessed to be remote, however significant the assessed potential impact.

The assessment period

3.10 **In making their assessment of the company's ability to continue to adopt the going concern basis of accounting and material uncertainties, directors should consider a period of at least 12 months from the date the financial statements are authorised for issue.**

3.11 Accounting standards provide for a minimum period that should be reviewed by directors as part of their assessment of going concern.[6]

3.12 When assessing the company's ability to continue to adopt the going concern basis of accounting, directors should consider all available information about the future at the date they approve the financial statements including the information from budgets and forecasts.

Reporting requirements

3.13 **Directors should disclose information about the going concern basis of accounting and material uncertainties that are necessary for the financial statements to give a true and fair view.**

3.14 In the financial statements, three reporting scenarios follow from the directors' assessment of the going concern basis of accounting and whether there are material uncertainties that require disclosure:

[6] FRS 102 paragraph 3.8 requires that the minimum period considered be at least, but not limited to, 12 months from the date the financial statements are authorised for issue. IAS 1 paragraph 26 requires that the minimum period considered be at least, but not limited to, 12 months from the reporting date (this will also apply for entities adopting FRS 101 *Reduced Disclosure Framework*).

	Basis of accounting	Disclosure requirements
a) **The going concern basis of accounting is appropriate and there are no material uncertainties.**	The directors should use the going concern basis of accounting when preparing the financial statements.	No specific disclosure requirements for the financial statements.
b) **The going concern basis of accounting is appropriate but there are material uncertainties related to events or conditions that may cast significant doubt upon the company's ability to continue to adopt the going concern basis of accounting in the future.**	The directors should use the going concern basis of accounting when preparing the financial statements.	When the directors are aware, in making their assessment, of material uncertainties related to events or conditions that cast significant doubt upon the company's ability to continue to adopt the going concern basis of accounting, the entity shall disclose those uncertainties.
c) **The going concern basis of accounting is not appropriate.**	The directors should use a basis other than that of a going concern when preparing the financial statements.	When a company does not prepare financial statements on a going concern basis, it shall disclose that fact, together with the basis on which it prepared the financial statements and the reason why the going concern basis of accounting is inappropriate.

Other disclosures

3.15 Accounting standards require other disclosures that may be relevant to the assessment of the going concern basis of accounting, solvency risk and liquidity risk. An overview of the main requirements is set out below.

Disclosure[7]	FRS 102	IFRS
Risks arising from financial instruments	11.48A(f), 34.23, 34.24, 34.28[8]	IFRS 7.31 to 42
Undrawn borrowing facilities and any restrictions on the use of those facilities such as covenant requirements	N/a	IAS 7.50(a)
Defaults and covenant breaches	11.47	IFRS 7.18 and 19
Significant judgements relating to the application of accounting policies	8.6	IAS 1.122
Sources of estimation uncertainty about the carrying amounts of assets and liabilities	8.7	IAS 1.125 to 133
Contingent liabilities	21.15	IAS 37.86 to 88

Financial instruments

3.16 FRS 102 and IFRS 7 *Financial Instruments: Disclosures* require a company to make both qualitative and quantitative disclosures concerning liquidity risk,[9] where it is a material financial risk.

3.17 Where liquidity risk is material, FRS 102[8] and IFRS 7 require:

- disclosure of information that enables users to evaluate the nature and extent of the company's exposure to liquidity risk arising from financial instruments;
- narrative disclosures explaining how liquidity risk arises and the company's objectives, policies and processes for managing the risk;
- summary numerical data about liquidity risk based on the information that is provided internally to key management personnel; and
- a maturity analysis of financial liabilities.

Summary of legal requirements

The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 also require similar disclosures for financial instruments in the directors' report.[10] These include the financial risk management objectives and policies of the company as well as its exposure to price risk, credit risk, liquidity risk and cash flow risk.

[7] The references in this document are to accounting standards that were effective at the date of publication of this Exposure Draft.
[8] The disclosure requirements in FRS 102 34.23, 34.24 and 34.28 apply to financial institutions only.
[9] Accounting standards define liquidity risk as the risk that an entity will encounter difficulty in meeting its obligations associated with financial liabilities that are settled by delivering cash or another financial asset.
[10] Schedule 7(6).

True and fair

3.18 The directors are responsible for ensuring that the financial statements give a true and fair view. Therefore, directors should consider whether additional disclosures are necessary when compliance with the explicit disclosure requirements of accounting standards relating to the going concern basis of accounting, material uncertainties and liquidity risk are insufficient to present a true and fair view.[11]

[11] The FRC paper *True and Fair* provides further information and is available at https://www.frc.org.uk/Our-Work/Codes-Standards/Accounting-and-Reporting-Policy/True-and-Fair.aspx.

4 Solvency and liquidity risks

Assessment

4.1 **Directors should consider threats to solvency and liquidity as part of their assessment of risks and uncertainties faced by the company.**

4.2 Liquidity risk is the risk that a company will be unable to meet its liabilities as they fall due. A company must generate and retain sufficient cash to allow it to meet its liabilities at the time contractual payments are due. The viability of an otherwise profitable company can be threatened if it is incapable of converting assets into cash when it is necessary to make such payments.

4.3 Solvency risk is the risk that a company will be unable to meet its liabilities in full. Over the long term a company must generate sufficient value such that its assets exceed its liabilities. A failure to do so could render it insolvent and threaten its viability.

4.4 The purpose of the assessment of risks and uncertainties is to enable directors to identify those matters that could affect the development, performance, position and future prospects of the company.

4.5 When making an assessment of risks and uncertainties, directors are encouraged to think broadly, considering all relevant matters that may threaten the company's development, performance, position and future prospects.

4.6 The extent of the process for assessing the risks and uncertainties and considering their implications should be appropriate to the size, complexity and particular circumstances of the company and is a matter of judgement for the directors. The assessment process is considered further in section 5.

The assessment period

4.7 **In making an assessment of the risks and uncertainties that may affect solvency and liquidity, directors should consider the likelihood and possible effects of those risks materialising.**

4.8 The period of the assessment will ultimately be a matter of judgement for the directors and will depend on the facts and circumstances of the company. Except in rare circumstances it should be significantly longer than 12 months from the approval of the financial statements.

4.9 The length of the period should be determined, taking into account a number of factors, including the nature of the business, its stage of development and its investment and planning time horizons.

4.10 Given the forward-looking nature of this assessment, the level of detail and accuracy of the information available relating to the future will vary.

Reporting requirements

4.11 The Companies Act 2006 requires all companies that are not small to prepare a strategic report. The strategic report must contain a fair review of the company's business, and a description of the principal risks and uncertainties it faces.

4.12 The strategic report should provide shareholders with information about the development, performance, position and future prospects of the company, consistent with the size, complexity and the particular circumstances of the company. The strategic report, by its nature, has a forward-looking orientation.

Disclosure of principal risks and uncertainties

4.13 **The strategic report should include a description of the principal risks and uncertainties facing the company, together with an explanation of how they are managed and mitigated.**

4.14 The risks and uncertainties included in the strategic report should be limited to those considered by the directors to be material to the development, performance, position or future prospects of the company. They will generally be matters that the directors regularly monitor and discuss because of their likelihood, the magnitude of their potential effect on the entity, or a combination of the two.

4.15 Where the directors consider that solvency or liquidity risks, uncertainties or other potential threats to a company's viability, are material, they should explain the particular economic or operational conditions giving rise to those risks and uncertainties. Issues that may require disclosure will depend upon individual facts and circumstances but may include:

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

4.16 Where relevant, the description of the principal risks and uncertainties facing the entity should highlight any linkage with disclosures relating to the going concern basis of accounting, material uncertainties and liquidity risk[12] in the financial statements.

Example

A company that is growing rapidly may need to ensure that it is able to access long-term financing to support its future development. The inability of the company to access this finance could result in liquidity risk and in extreme circumstances lead to insolvency. Directors may have actions planned for mitigating this risk e.g. obtaining a bank loan or raising funds through the issue of shares. It is likely that the need for such funds and the planned actions will need to be disclosed as a principal risk in the strategic report. Directors should also consider whether the risk of not raising sufficient finance represents a material uncertainty relating to the going concern basis of accounting requiring disclosure in the financial statements.

[12] There is no specific disclosure requirement in accounting standards for solvency risk; however, this will also be a consideration in the context of the financial statements.

5 The assessment process

5.1 This section sets out factors to consider and techniques that may be applied in identifying principal risks and uncertainties to disclose in the strategic report, assessing whether the going concern basis of accounting is appropriate and whether there are material uncertainties that cast significant doubt that it will continue to be a going concern.

5.2 Directors are best placed to assess which factors are likely to be relevant to their company. These factors will vary according to the size, complexity or the particular circumstances of the company, its industry and the general economic environment. Some of these factors will be more relevant to the strategic report assessment of risk whereas others will be more relevant to the assessment of the going concern basis of accounting and financial statement disclosures.

5.3 The extent of the directors' review process will depend upon the size, complexity and the particular circumstances of the company. Some companies tend to be dependent upon fewer providers of finance, have fewer business activities and a more limited number of creditors including the tax authorities. As a result the process and procedures for those companies are likely to be simpler and less extensive than those for more complex companies. However, it is still important that the assessment is carried out and addresses, to the extent necessary, the directors' plans to manage the company's borrowing requirements, the timing of cash flows and the company's exposure to contingent liabilities.

5.4 The level of detail applied in the analysis of these factors will depend on the scale and nature of the risks a company faces and the time horizon over which the analysis is applied. Longer-term assessments, such as those that will inform the disclosures in the strategic report, are likely to be performed at a higher, more aggregated level reflecting the difficulties in making detailed long-term predictions.

Forecasts and budgets

5.5 Forecasting and budgeting are long-established techniques in business management. For the purposes of assessing risks and whether the going concern basis of accounting is appropriate, directors should prepare a budget, trading estimate, cash flow forecast or other equivalent analysis covering such periods as they consider appropriate.

Timing of cash flows

5.6 Directors should assess whether their financial plans indicate an adequate matching of projected cash inflows with projected cash outflows. The projected outflows should include liabilities, such as loan repayments, payment of tax liabilities and other commitments.

Sensitivity analysis

5.7 Sensitivity analysis involves measuring the impact on forecasts of changing relevant assumptions within reasonably possible ranges and provides directors with an understanding of the critical assumptions that underlie such forecasts. As an example, directors might consider the impact of varying assumptions of future revenue levels on the company's compliance with current financing covenants and the need for future additional financing. The extent of analysis should be proportionate to the size, complexity, the particular circumstances of the company and the risks it faces. It may, depending upon the facts and circumstances, be appropriate to test the impact of changes of the following:

- interest rates;
- exchange rates;
- market share;
- raw material costs;
- expected selling costs;
- a customer or supplier failing;
- availability of borrowings;
- margin requirements consequent on varying underlying prices relevant for derivative contracts during their life;
- likely extent of damages arising from unfavourable legal judgements; and
- taxation rates.

Products, services and markets

5.8 Directors should obtain information about the major aspects of the economic environment within which the company operates. They should consider the size of the market, its strength, their market share and assess whether there are any economic, political or other factors which may cause the market to change. This should be done for each of the main product or service markets.

5.9 Directors should assess whether their products or services are compatible with their market projections in terms of market position, quality and expected life.

Financial and operational risk management

5.10 There are many types of financial and operational risks facing a company and directors should identify which risks are most significant. For example, exposure to fixed-price contracts and to movements in foreign currency exchange rates may be the most significant risks for a construction company engaged in overseas markets.

5.11 Consideration should also be given to counterparty risks that arise from reliance on key suppliers or customers who may themselves be facing financial difficulty. The directors should consider how such risks could affect the company and how they are managed in practice.

Borrowing facilities

5.12 The availability of borrowing facilities may be dependent upon the company's compliance with specific terms and conditions (covenants). An analysis of borrowing documentation should be undertaken to ensure that all critical terms and conditions are identified so that the risks to continued compliance can be assessed.

5.13 The availability of borrowing facilities is also likely to depend on the lenders' assessment of the risks to the viability of the company, amongst other factors. The directors should also consider the likely relevance of the outcome of their assessment to the continuation or renewal of existing facilities beyond contractual periods.

5.14 If there is uncertainty over the contractual arrangements with lenders and other providers of finance, directors should seek confirmation from the lenders of the principal terms and conditions. However, the absence of confirmations does not necessarily cast significant doubt upon the ability of a company to continue as a going concern.

5.15 The onus is on the directors to be satisfied that there are likely to be appropriate and committed financing arrangements in place. The facilities available to the entity should be compared to the entity's expected cash requirements from such facilities, as indicated by the cash flow forecasts, budgets or trading estimates. Where necessary, early discussion of any potential deficits, arrears or contractual breaches with the company's providers of finance may prevent potential problems crystallising.

Contingent liabilities[13]

5.16 Directors should consider the company's exposure to contingent liabilities. These should include sources of potential cash outflows during the review period relating to legal proceedings, guarantees, margin or other credit support provisions under derivative contracts, environmental costs and product liability.

Subsidiary companies

5.17 Directors of subsidiary companies need to make their own assessment to support disclosure of the principal risks and uncertainties facing the company in the strategic report and of the subsidiary's ability to continue to adopt the going concern basis of accounting, taking into account the specific facts and circumstances of the subsidiary company and in particular:

- the need for support[14] from the parent company or fellow subsidiaries;
- the ability and willingness of the parent company or fellow subsidiaries to provide such support; and
- the risks to the company's going concern status arising from support that it has undertaken to provide to other members of the group.

5.18 The directors should consider the degree of autonomy exercised by the subsidiary company, how the subsidiary's business fits into the group's activities and future plans, and the particular business risks the group faces. The adequacy of the evidence of any parent company support is a matter of judgement for the directors of the subsidiary company. Their judgement usually incorporates their experience of dealing with the parent company over time, taking into account recent events and current circumstances. This includes considering the development, performance, position and future prospects of the group.

[13] Defined in FRS 102 as: (a) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence of one or more uncertain future events not wholly within the control of the entity; or (b) a present obligation that arises from past events but is not recognised because: (i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or (ii) the amount of the obligation cannot be measured with sufficient reliability.

[14] 'Support' for this purpose encompasses both financial and non-financial support.

6 Materiality and placement of disclosures

Materiality

6.1 **Disclosures relating to solvency risk and liquidity risk should only be provided when material.**

6.2 Information is material if its omission or misrepresentation could be reasonably expected to influence the economic decisions users take on the basis of the annual report as a whole. The inclusion of immaterial information can obscure key messages and impair the understandability of information provided in the annual report.

6.3 The assessment of materiality is dependent on the context of its application. For the strategic report principal risks will be identified as those that are considered material to a user's understanding of the development, performance, position or future prospects of the business.

6.4 In the context of the financial statements, FRS 102 states that 'Information is material, and therefore has relevance, if its omission or misstatement, individually or collectively, could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances'.[15]

Placement of disclosures

6.5 **Directors should consider the placement of disclosures with a view to facilitating the effective communication of that information.**

6.6 Company law and accounting standards set the requirements for disclosures relating to principal risks and uncertainties and the going concern basis of accounting. This may result in the inclusion of these disclosures in different components of the annual report (e.g. strategic report and financial statements). This may make it difficult for users to identify the linkages between the different pieces of information. In these instances, it may be helpful to use signposting to direct users to related information included in different parts of the annual report.

6.7 Signposting is a means by which a user's attention can be drawn to complementary information that is related to a matter disclosed in a component of the annual report. A component must meet its legal and regulatory requirements without reference to signposted information. Signposts should make clear that the complementary information does not form part of the component from which it is signposted. Signposted information may be located either within or separately from the annual report.

6.8 In some instances, it may be helpful to group together similar or related disclosure requirements arising from different legal or regulatory requirements that apply to different components of the annual report. This will reduce duplication and enable linkages to be highlighted and explained clearly in one place.

6.9 Where law or regulation specifies the location for a disclosure (e.g. financial statements) and the information is presented outside of the specified component, cross-referencing must be used in order for the disclosure requirement to be met.

[15] A similar description is included in the IFRS *Conceptual Framework for Financial Reporting* (September 2010), paragraph QC11.

6.10 Cross-referencing is a means by which an item of information, which has been disclosed in one component of an annual report, can be included as an integral part of another component of the annual report. A cross-reference should specifically identify the nature and location of the information to which it relates in order for the disclosure requirements of a component to be met through the relocated information. A component is not complete without the information to which it is cross-referenced. Cross-referenced information must be included within the annual report. Cross-referencing is different to signposting.

7 Auditor reporting

7.1 The purpose of this section is to help directors understand the responsibilities the auditor has in connection with the directors' assessment of the company's ability to continue to adopt the going concern basis of accounting (the 'directors' assessment') and related disclosures in the financial statements or annual report.

The auditor's responsibilities

7.2 Auditors are required by auditing standards[16] to conclude whether it is appropriate for the directors to use the going concern basis of accounting to prepare the financial statements and also whether a material uncertainty exists about the company's ability to continue to do so.

7.3 There are implications for the auditor's report where the auditor concludes that a material uncertainty exists and also where the auditor disagrees with the directors' use of the going concern basis of accounting or the adequacy of the disclosures made by the directors in the financial statements.

Evaluating the directors' assessment

7.4 The auditor is required to evaluate the directors' assessment. As described in section 3, in performing their assessment the directors should take into account all available information about the future, the realistically possible outcomes of events and changes in conditions and the realistically possible responses to such events and conditions that would be available to the directors.

7.5 In evaluating the directors' assessment, the auditor considers all relevant information of which the auditor is aware, including all available information the directors used to make their assessment, and any knowledge obtained by the auditor during the audit.

7.6 The auditor covers the same period as the directors used to make their assessment. As set out in paragraph 3.10 of this guidance, in making their assessment of going concern and material uncertainties, the directors should consider a period of at least 12 months from the date of approval of the financial statements. If the period of the directors' assessment is less than 12 months from the date of approval of the financial statements, the auditor may consider it necessary to modify their audit opinion or disclose this fact in their auditor's report.

7.7 As part of the auditor's risk assessment procedures, the auditor also considers whether there are any events or conditions – either identified by the directors as part of their assessment or in addition to those – that may cast significant doubt on the company's ability to continue to adopt the going concern basis of accounting. If any events or conditions are identified, the auditor concludes whether a material uncertainty related to those events or conditions exists.

Disclosures

7.8 As part of the audit, the auditor considers disclosures relating to solvency risk, liquidity risk and the going concern basis of accounting made in the annual report. Where the directors have concluded that there is a material uncertainty, the auditor considers the relevant disclosures, including the principal events and conditions that may cast significant doubt on the company's ability to continue to adopt the going concern basis of accounting and the directors' plans to deal with those events or conditions.

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[16] International Standard on Auditing (UK and Ireland) 570 "Going Concern" (Revised), (September 2014).

7.9 Where the auditor has concluded that a material uncertainty related to the going concern basis of accounting exists, the auditor also has a specific requirement to determine whether the financial statements 'disclose clearly that there is a material uncertainty' relating to going concern.

Reporting

7.10 Where a material uncertainty exists, the auditor highlights it in a separate section of the auditor's report, provided that the circumstances are fully explained in the financial statements.

7.11 If the auditor concludes that the disclosures are not adequate to meet the requirements of accounting standards and the Companies Act 2006, or that the financial statements do not include adequate disclosures to give a true and fair view, the auditor modifies their opinion and provides the reasons for doing so.

7.12 In some circumstances, the auditor may be required to describe in the auditor's report matters which they have assessed as being of particular significance to the audit. These matters may include going concern where it has, for example, involved significant director or auditor judgement or has had significant impact on the audit in terms of resource and effort.

7.13 The auditor is also required to read the directors' report and, where it is prepared, a strategic report or a separate corporate governance statement, and to state in their report whether the information:

- is consistent with the financial statements; and
- has been prepared in accordance with company law or accounting standards.[17]

7.14 The auditor also reads other information contained in the annual report and considers whether there is a material inconsistency between the other information and the auditor's knowledge obtained in the course of the audit and reports accordingly in their report.

[17] The Companies Act 2006 as amended by The Companies, Partnerships and Groups (Accounts and Reports) Regulations 2015 requires these statements for periods commencing on or after 1 January 2016.

Appendix A: Application to other reports

A1–A2 apply mainly to listed companies as defined in the FCA Handbook, broadly those with equity shares or debt securities listed in the UK official list, but may also be relevant to other companies that prepare half-yearly financial reports or preliminary announcements.

A1 Half-yearly financial reports

Assessment

A1.1 The Financial Conduct Authority's Disclosure and Transparency Rules (DTR) 4.2 require companies whose shares or debt securities are admitted to trading on the main market to prepare a half-yearly financial report that includes an interim management report and condensed financial statements. There are also requirements in respect of half-yearly financial reports for companies admitted to trading on the Alternative Investment Market, ISDX Main Board or NYSE Euronext London.

A1.2 Directors will need to exercise judgement about the nature and extent of the procedures that they apply to assess the appropriateness of the going concern assumption at the half-yearly reporting date and the need for disclosures about new activities, events and circumstances. Issues which might trigger a need to re-examine the going concern basis of accounting and disclosures around solvency and liquidity risk include:

- a significant adverse variation in operating cash flows between prior budgets and forecasts and the outturn in the first half of the year;
- a significant reduction in revenues or margins forecast for the second half of the year;
- a failure to obtain renewal or extension of bank facilities that had been anticipated; and
- a failure to sell capital assets for their expected amounts or within previously forecast time-frames.

A1.3 If the going concern bais of accounting has become a significant issue since the last annual financial statements, directors should undertake procedures similar to those that they would have carried out for annual financial statements to ensure that all relevant issues and risks have been identified and considered.

A1.4 Where no new issues have been identified that raise questions about the assessment made at the last year end, the directors will need to undertake procedures to roll forward the previous budgets and forecasts by a half-yearly period.

The assessment period

A1.5 Under this Guidance, directors of all companies should consider all available information about the future at the date of approval of half-yearly financial statements including the information obtained from budgets and forecasts.

A1.6 Companies subject to the DTR are required to produce a half-yearly financial report that includes condensed financial statements. Where such companies use IFRS they are required to apply IAS 34 *Interim Financial Reporting*. It provides that the same recognition and measurement principles be applied to interim financial statements as are applied to annual financial statements. Consequently, the minimum review period requirement in paragraph 26 of IAS 1 applies to financial statements for an interim period as described in IAS 34. Where such companies use FRS 102, they may apply FRS 104 *Interim Financial Reporting*.

Disclosure

A1.7 DTR 4.2.7 requires that the interim management report must include a description of the principal risks and uncertainties for the remaining six months of the year.

A1.8 IAS 34 and FRS 104 provide that entities may elect to provide less information at interim dates, as compared with their annual financial statements, in the interests of timeliness and cost considerations and to avoid repetition of information previously reported. Instead, the focus of interim financial statements is on new activities, events and circumstances which have not previously been reported.

A1.9 Directors will need to exercise judgement in determining the disclosures about going concern and liquidity risk that they should include in a set of interim financial statements. However, the condensed financial statements should provide a true and fair view.

A1.10 Practical experience suggests that new events and circumstances are likely to arise quite often in businesses facing financial difficulties, for example as borrowings are renegotiated and assets and businesses are sold or closed. In these circumstances, it is likely that half-yearly financial statements will include additional disclosures about the going concern basis of accounting and liquidity risk.

Auditor's half-yearly review report

A1.11 The directors may engage the auditor to review the half-yearly financial statements. The FRC's International Standard on Review Engagements (UK and Ireland) 2410 *Review of interim financial information performed by the independent auditor of the entity* requires the auditor, among other things, to inquire whether the directors have changed their assessment of the company's ability to continue to adopt the going concern basis of accounting.

A1.12 When the auditor becomes aware of events or conditions that may cast significant doubt on the company's ability to continue as a going concern, the auditor is required to inquire of the directors as to their plans for future actions, the feasibility of those plans and whether the directors believe that the outcome of those plans will improve the situation.

A1.13 The auditor is required to consider the adequacy of the disclosures about the going concern basis of accounting in the half-yearly financial statements and, where there is a material uncertainty that may cast significant doubt on the company's ability to continue to adopt the going concern basis of accounting (and the disclosures made are adequate), to add an emphasis of matter to its review report. If such a material uncertainty exists which is not adequately disclosed, the auditor is required to express a qualified or adverse conclusion.

A2 Preliminary announcements

Disclosure

A2.1 Preliminary announcements of annual results form one of the focal points for investor interest.

A2.2 Under the Listing Rules such announcements are voluntary, although if made their contents are subject to minimum requirements.

A2.3 Directors may need to consider whether, in light of the requirement 'to include any significant additional information necessary for the purpose of assessing the results being announced' (Listing Rule 9.7A.1 (5)) they need to make appropriate disclosures about the going concern basis of accounting in their preliminary announcements.

A2.4 Another requirement (Listing Rule 9.7A.1 (2)) is that 'If a listed company prepares a preliminary statement of annual results the statement must be agreed with the company's auditor prior to publication'. The Listing Rules also require specific disclosure of the nature of any likely modification or emphasis of matter contained in the auditor's report that is to be included with the annual financial report.

This draft is issued by the Financial Reporting Council for comment. It should be noted that the draft may be modified in the light of comments received before being issued in final form.

For ease of handling, we prefer comments to be sent by e-mail to:

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Comments may also be sent in hard copy to:

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Comments should be despatched so as to be received no later than 15 January 2016.

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ISBN 978-0-7545-5357-1
9 780754 553571