

Need to know

FRC issues guidance on going concern and reporting on solvency and liquidity risks for non-Code companies



In a nutshell

- The FRC has issued the final version of their best practice guidance on the going concern basis of accounting and reporting on solvency and liquidity risks for companies that do not apply the UK Corporate Governance Code ('non-Code companies').
- The guidance is a simplified version of the going concern elements of the FRC's September 2014 update to the Corporate Governance Code and related guidance, and incorporates recent developments in corporate reporting.
- Small and micro-companies are excluded from the scope of this guidance, although it may function as a useful aid for directors of small companies in assessing whether the going concern basis of accounting is appropriate and whether any disclosure may be required in order for financial statements to give a true and fair view.
- The final guidance replaces *Going Concern and Liquidity Risk: Guidance for Directors of UK Companies 2009* and can be applied with immediate effect.

Background

For those companies that are required to apply the UK Corporate Governance Code the FRC implemented the recommendations of the 2012 Sharman Inquiry on going concern and liquidity risk, as part of their 2014 update to the Code. It also published supporting *Guidance on Risk Management, Internal Control and Related Financial and Business Reporting* which also applies to companies adopting the UK Corporate Governance Code.

This new guidance has been issued for those companies that do not apply the UK Corporate Governance Code. Some companies apply the Code because they are required to do so (e.g. premium listed companies) and others do so voluntarily (e.g. some companies with a standard listing and some AIM companies). The guidance therefore addresses all other companies, although it specifically excludes small and micro companies. This spans a range including large and medium-sized privately-owned businesses and most AIM companies.

The guidance includes a useful table that illustrates the various requirements for different sizes of company:

Main requirements	Source of requirements	Micro entity	Small company	Large and medium-sized company	Guidance paragraph reference
Financial statements					
Assessment of the appropriateness of the going concern basis of accounting	FRS 105 – 3.3 FRS 102 – 3.8 IAS 1 – 25	✓	✓	✓	3.1 to 3.6
Disclosure when there are material uncertainties or that the company does not prepare financial statements on a going concern basis of accounting	FRS 102 – 3.9 IAS 1 – 25	x	x	✓	3.7 to 3.8
Additional disclosures that may be required to give a true and fair view	Companies Act 2006 – s393	x	✓	✓	3.9 to 3.10
Other relevant financial statement disclosures	FRS 102 IFRS 7 IAS 1 IAS 37	x	x	✓	4.10 to 4.12
Strategic report					
The strategic report must contain a description of the principal risks and uncertainties facing the company	Companies Act 2006 – s414C(2)(b)	x	x	✓	4.1 to 4.9

The guidance draws on the requirements of company law, accounting standards, auditing standards and other regulation. It is a simplified version of the going concern and risk reporting elements of the FRC's guidance for Code companies. It also incorporates many of the key points and principles from the 2009 Guidance. The guidance is non-mandatory and is intended as best practice advice for non-Code companies.

What is included in the guidance?

Going concern basis of accounting

Directors of all companies are required to assess whether the adoption of the going concern basis of accounting when preparing the financial statements is appropriate. In carrying out this assessment consideration should be given to the size, complexity and circumstances of the business. Under FRS 102 directors should consider a period of at least 12 months **from the date the financial statements are authorised for issue**. This compares to the requirement under IAS 1 *Presentation of Financial Statements* that the period considered is at least 12 months **from the end of the reporting period**. However auditor requirements require auditors to assess a period of at least 12 months **from the date of approval of the financial statements**.

Observation

There is no requirement for a longer-term viability statement for non-Code companies. This is a requirement for Code companies for periods commencing on or after 1 October 2014 as part of the 2014 revisions to the Code.

In addition, consideration should be given by all companies (other than small or micro companies) to whether there are any material uncertainties relating to events or conditions that may cast significant doubt about the continuing use of the going concern basis of accounting in future periods. Whether an uncertainty should be considered material and therefore disclosed in the financial statements is a matter of judgement as to whether its disclosure could reasonably be expected to affect the economic decisions of shareholders and other users of the financial statements.

Reporting requirements

The three reporting scenarios that may result from the directors' assessment of going concern, and the related disclosure requirements, are as follows:

		Basis of accounting	Disclosure requirements
1	The going concern basis is appropriate and there are no material uncertainties.	Going concern basis	No specific disclosure requirements.*
2	The going concern basis is appropriate but there are material uncertainties related to events or conditions that may cast significant doubt upon a company's ability to continue to adopt the going concern basis of accounting in the future.	Going concern basis	Disclosure of material uncertainties.
3	The going concern basis is not appropriate	Basis other than going concern	Disclosure of the fact that the financial statements are not prepared on the going concern basis together with the basis on which they were prepared and the reason why the going concern basis of accounting is inappropriate.

* The draft guidance clarifies that there are no specific disclosure requirements for financial statements when the going concern basis is appropriate and when there are no material uncertainties. This differs from the 2009 Guidance which encouraged disclosure even if there were no material uncertainties. However, disclosure may still be relevant in the context of principal risks and uncertainties as disclosed in the strategic report (see below).

In making their going concern assessment directors should consider whether additional disclosures are necessary in order to present a true and fair view as there may be circumstances in which disclosure is needed beyond the explicit requirements in accounting standards. The FRC gives two examples where the financial statements might give the impression there was a going concern issue without explanation as to why there might not be a significant issue. For example, it may be appropriate to disclose ongoing financial support from a parent in the accounts of a subsidiary company that has substantial net liabilities in order to give a true and fair view of the going concern position of that subsidiary.

Solvency and liquidity risks

When presenting the strategic report, directors should consider threats to solvency and liquidity as part of their assessment of risks and uncertainties faced by the company:

- Liquidity risk is the risk that a company will be unable to meet its liabilities as they fall due.
- Solvency risk is the risk that a company will be unable to meet its liabilities in full.

In making their assessment, directors should consider the likelihood and possible effects of those risks materialising for a period usually longer than 12 months from the authorisation of the financial statements.

All companies, apart from small companies, are required to produce a strategic report under the Companies Act 2006. 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.

Where there are solvency or liquidity risks that are considered material, directors should explain the particular economic or operational conditions that give rise to those risks and the potential impact on specific aspects of the business. Although issues will depend upon individual facts and circumstances, the guidance includes some example issues that may be appropriate:

- uncertainties about current financing arrangements;
- potential changes in financing arrangements, e.g. critical covenants and any need to increase current borrowing levels;
- counterparty risks arising from current credit arrangements 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.

Observation

Disclosures relating to solvency and liquidity risk should only be provided when material. The inclusion of immaterial information can mask key messages and affect the understandability of information provided in the annual report.

The Deloitte publication **Thinking allowed – Materiality**, issued in September 2015, provides guidance on applying the concept of materiality to those responsible for preparing, or approving for release, a general purpose financial report.

Certain accounting standards require other disclosures that may be relevant to an understanding of solvency risk and liquidity risk. This includes disclosure requirements on contingent liabilities, under FRS 102 21.15/IFRS 37.86 to 88, and on defaults and covenant breaches, under FRS 102 11.47/IFRS 7.18 and 19.

The assessment process

Section 5 of the guidance sets out factors for directors to consider (and techniques that may be applied) in identifying principal risks and uncertainties to disclose in the strategic report, and in assessing whether the going concern basis of accounting is appropriate. These include the use of forecasts and budgets in addition to sensitivity analysis and an assessment of a company's borrowing facilities and any contingent liabilities. It also contains guidance specific to directors of subsidiary companies and of companies that are owned by, or dependent on, the government.

Auditor reporting

Auditing standards require auditors to evaluate the directors' going concern assessment and to conclude whether it is appropriate. Auditors also have a responsibility to consider whether the other information included in the annual report, including the description of any solvency and liquidity risks disclosed, is materially misstated.

Where auditors conclude that the use of the going concern basis of accounting is appropriate and they have not identified any material uncertainty then they are required to state in the auditor's report that they have no matters to report in this regard. Where a material uncertainty does exist auditors should highlight it in a separate section of their report. If auditors determine that any disclosures made are inadequate to meet the requirements of accounting standard or of the Companies Act 2006 then they will modify their audit opinion and provide details as to why they are doing so.

Interim reporting

In preparing any interim financial statements, directors must consider whether the going concern basis of accounting is appropriate. If there have been any significant issues since the last annual financial statements that cast doubt on the continuing appropriateness of using the going concern basis of accounting then directors should carry out similar procedures to those carried out for annual financial statements. Any material uncertainties reported at the year-end date that still exist as at the interim reporting date should be disclosed in the half-yearly financial statements.

Where a half-yearly report includes principal risks and uncertainties, directors will need to update the assessment of these made in the previous annual report. This assessment should involve a consideration of any new activities, events or circumstances since the year-end date that indicate that the previous assessment of risks should be changed.

Small and micro companies

Although the scope of the draft guidance excludes small and micro companies, such entities may find some aspects of the guidance relevant. Small and micro companies are not required to prepare a strategic report but must assess whether the going concern basis of accounting is appropriate in preparing their financial statements.

Micro companies applying FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime* 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 explicitly required by those standards to provide disclosures on the going concern basis of accounting. However the directors of small companies should provide such disclosures if judged necessary in order to meet their responsibility to prepare financial statements that give a true and fair view. Appendix D of section 1A of FRS 102 encourages the inclusion of disclosure where there is a material uncertainty; for audited financial statements, it is unlikely that given the auditor's responsibilities they could accept non-disclosure if there was a material going concern uncertainty.

Further information

If you have any questions about the subjects raised in this publication, please speak to your normal Deloitte contact. More information on the existing UK reporting framework, as well as other UK accounting, reporting and corporate governance news and publications, can be found at www.ukaccountingplus.co.uk

The FRC Guidance on the Going Concern Basis of Accounting and Reporting on Solvency and Liquidity Risks can be found at www.frc.org.uk

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