For minor celebrities the old adage that ‘any press is good press’ may still hold true. But for companies, which rely on the confidence of lenders, customers and suppliers for their continued operation, the manner in which financial information is reported and understood is of vital importance. As the 2008 year-end reporting season looms, the judgment directors and auditors must make on whether a company is a going concern is emerging as a highly sensitive issue.

As the UK economy deteriorates, there is more and more evidence of the negative impact on profitability and cash flow across all sectors. Lending institutions, already inclined to be more risk averse, are becoming less likely to renew existing credit lines. In this challenging environment, directors may have to conclude that they need to disclose material uncertainty in the accounts, leading to significant doubt about the company’s ability to continue as a going concern.

Anything which could be seen as likely to spook lenders or the supply chain into knee-jerk decisions is clearly not desirable for business at any time. Directors are understandably nervous about doing so but it is their duty under international financial reporting standards and UK GAAP: ‘In making their 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, those matters need to be disclosed.’

What’s more, it’s then the auditor’s duty to refer to it in the audit report. Where the uncertainty has been adequately disclosed, the auditor will issue an unqualified report, modified by including an ‘emphasis of matter’ paragraph highlighting those disclosures. Where it has not been adequately disclosed, the auditor will issue a qualified report, stating the reasons why, or give an adverse opinion.

Going concern uncertainty is not necessarily an indication that a company will go under, nor an indication of future prospects. But are the technicalities and meaning of ‘modified’, ‘qualified’ or ‘emphasis of matter’, widely understood within the UK’s financial system? Not so, according to the ICAEW.

Auditors know a modified audit report does not necessarily indicate crisis. Investors, lenders and the press need to understand the directors are being transparent about uncertainty.
In an effort to **prevent misunderstanding in the market** leading to unnecessary further difficulties for business, the institute has embarked on an awareness raising campaign among government, lenders and businesses.

**Avoiding damaging reactions**

In an effort to prevent misunderstanding in the market leading to unnecessary further difficulties for business, the institute has embarked on an awareness raising campaign among government, lenders and businesses. It is encouraging the accountancy profession to work with the banking industry, government and regulators as well as the media, to explain the difference between a modified and qualified report and avoid the use of misleading or emotive language in the press. ‘All those in the financial reporting chain have a responsibility to respond to going concern issues in a measured and informed way. Doing so will help support business confidence and contribute towards wider economic recovery,’ says ICAEW CEO Michael Izza.

Auditors predict that the proportion of 2008 year-end annual reports containing disclosures relating to going concern and liquidity is likely to rise significantly compared with previous years, as is the number of modified audit reports.

‘In current economic conditions, going concern issues have assumed a level of importance never encountered before,’ says Martyn Jones, national audit technical partner at Deloitte. ‘A recent survey found that the current level of going concern emphasis of matter is 5%, but of course that’s before the main reporting season starts.’

Audit firms are keen to help the ICAEW get its message across because of the potential impact on the wider economy. ‘It is a fact that if there is a going concern emphasis of matter it may have an impact, not only on bankers, but also on employees, customers, suppliers and joint venture partners,’ says Jones. ‘It’s an extremely sensitive area.’

For example, in the current market, ill-informed over-reactions may mean that a lender withdraws or declines to renew credit facilities, damaging an otherwise viable business that may be reliant on those credit arrangements. In some cases, a modified audit report could be wrongly interpreted as breaching loan covenants that require an unqualified report. Suppliers may stop or interrupt providing credit facilities to a business, disrupting its trading activities. Landlords may seek to enforce break clauses in property lease arrangements.

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Banks, however, say they do not rely solely on audit reports when making judgments on corporate clients. They will assess small businesses in particular using weekly or monthly data. ‘Very often an emphasis of matter won’t be a surprise to the banks,’ says Geoff Swales, director in PricewaterhouseCoopers’ audit technical group. ‘They have got far more information about the company on an ongoing basis than auditors who come in towards the end of the year. I doubt that it will have a significant impact on the bank’s reaction in most cases.’

This situation notwithstanding, in the current climate it is a leap of faith to be certain that all banks and finance providers on the high street will be unlikely to react negatively to a modified report. For this reason, the institute is supportive of any moves by the banking community to provide clarity directly to bank staff on the differences between modification and qualification.

**Management response**

Caught between a rock and hard place, what can, or should, directors do? The Financial Reporting Council is encouraging directors of listed companies to use its

- Careful evaluation and appropriate disclosure of liquidity risk and uncertainties necessary to give a true and fair view
- Make the assessment at the date that directors approve the annual report and accounts – degree of consideration to depend on the facts of each case
- Consider carefully information available and assumptions as to the future availability of finance: assess the probability of an event occurring and impact if it does
- Explain the principal risks and uncertainties facing the company arising from current difficult economic conditions
- Consider the three conclusions on going concern based on evaluation of specific circumstances of the business:
  - No material uncertainties leading to significant doubt about ability to continue
  - Material uncertainties leading to significant doubt about ability to continue
  - The use of the going concern basis is not appropriate.

An update for directors of listed companies: going concern and liquidity risk (November 2008), Financial Reporting Council. The FRC suggests its update may also be useful for directors of unlisted companies who have similar responsibilities to assess going concern and make appropriate disclosures.
Wrongful trading health warning

Some directors might be tempted to avoid disclosing uncertainties in the accounts which could lead to modified audit reports. They might be anxious about such disclosure alarming their banks and creditors. And if that resulted in lack of credit or cashflow, it could potentially lead to insolvency concerns, which would raise the spectre of wrongful trading and the directors becoming personally liable for the company’s debts. But failure to disclose would be the wrong thing to do.

Disclosures on going concern uncertainty do not necessarily mean the end, as emphasised by the FRC’s guidance for directors: ‘Doubts about the ability of a company to remain a going concern do not necessarily mean that the company is, or is likely to become, insolvent.’ Such doubts therefore do not of themselves signify that the directors could be wrongfully trading. That happens when directors continue to trade where there is ‘no reasonable prospect’ that the company could avoid going into insolvent liquidation. In such cases, the directors could be liable to make up any losses unless they can show they took every step to try and minimise the potential loss to the company’s creditors.

During recession, helping the market recognise that present difficulties may not be long-term difficulties is clearly good for the jobs and communities businesses support. In its meetings with MPs and evidence to select committees, the institute has called for public dialogue and parliamentary scrutiny of going concern uncertainty issues in order to advise and educate the wider market.

Any press may not be good press, but a sensible public dialogue is an important part of ensuring a reasoned and measured response to the going concern issue.

Auditors predict that the proportion of 2008 year-end annual reports containing disclosures relating to going concern and liquidity is likely to rise significantly recently published guidance regarding going concern and liquidity risk disclosures in the current difficult economic climate. The institute welcomes this guidance and recommends that listed company directors make themselves familiar with its contents at an early stage.

As the FRC guidance points out, doubts about the ability of a company to remain a going concern do not necessarily mean that the company is, or is likely to become, insolvent. Solvency is determined by reference to a comparison of its assets and liabilities and by its ability to meet liabilities as they fall due. This needs to be more widely understood. The guidance recommends that where the directors are unable to state that the going concern basis is appropriate, they should consider taking professional advice.

The institute is encouraging businesses to make sure they communicate openly and on an early basis with their auditors and advisers if they need extra help. It warns audit committees to monitor the effectiveness of internal control and review their internal risk management policies. It is vital that independent directors have the requisite expertise, skills and commitment to fulfil their roles properly. As the chairman of the Non-Executive Directors Association Graham Durgan has pointed out, ‘Non executives have a particular responsibility at this time to ensure the law is complied with.’

The institute’s widely publicised Top Ten Tips focus on managing and closely monitoring cashflow and credit rating including, most importantly, good communication with all finance providers, customers and suppliers.

Looking at past business performance, Swales at PwC believes a modified audit report is by no means ‘a death sentence’. ‘If you went back a year,’ he says, ‘and found audit reports that had a going concern emphasis of matter, I suspect most of those companies would still be in existence.’