

ARE THE DAYS OF A VANILLA GOING CONCERN STATEMENT NUMBERED?

Many companies have year ends on 31 December or 31 March. The credit crunch and the lack of liquidity and capital of the banks as they battle with Basle, 2 are well documented. However is the next crisis of confidence about to hit corporates and private equity houses as auditors argue there are material uncertainties existing around portfolio company's going concern or as a minimum will we see auditors including as almost standard emphasis of matters statements in their reports? "Material uncertainties" could be the by-word for audited accounts in 09.

Further the Business Review now required by the Companies Act 2006 in directors reports could become the key area of debate in a report and accounts. A Business Review requires "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". It requires "a description of the principal risks and uncertainties facing the business". In this economic climate Business Reviews are almost certainly going to speak about uncertainties around current financing arrangements (whether committed or uncommitted), potential changes in financing arrangements such as critical banking covenants, risks arising out of current credit arrangements including the loss of credit insurance, heightened dependency on the performance of key suppliers and customers and the uncertainties surrounding the potential impact on the economic outlook to business in general.

With the codified duties of directors having been introduced, under the new UK Companies Act, directors have an increased exposure in relation to their assessment in supporting a going concern statement and appropriate regulatory disclosures. Accounting standards require directors to make an assessment of the company's ability to continue as a going concern and requires them to disclose uncertainties that they are aware of in making that assessment. This requirement has existed for a long time but is likely to have an increased significance as we enter into a period of recession.

It is going to be necessary for directors to provide evidence to support their conclusions and have detailed contingency remedial action plans. The squeeze on corporate cash flows means that liquidity risk is likely to be a material risk for many more entities this year. As a consequence, a greater number of companies are likely to need to present relevant disclosures concerning liquidity risk in their directors reports. In addition to cash flow, risk will arise from writing down of inventories and goodwill impairments. We are already seeing significant write downs of goodwill in publicly quoted private equity firms.

While it is standard for auditors to ask for bank lenders to confirm facilities as part of a year end process, we are entering into a period when bankers may be reluctant to provide positive confirmations that facilities will continue to be available. Are we likely to

see banks responding in the current economic environment by stating as “a matter of policy” they will not provide such confirmation to its customers and auditors.

Such a failure to confirm facilities does not mean that the accounts have to be qualified but it may well lead to increased disclosures on liquidity risk and material uncertainties which are likely to require further work to be undertaken by directors to show what future plans they have to deal with financing risk. Basically the greater the risks, the more work will be required to give auditors the comfort on going concern.

As directors have long pointed out, assessing the going concern assumption involves making a judgement 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 judgement is being made about the outcome of the event or condition. The “classic” warranty one sees in investment agreements about reasonable based opinions on reasonable forecasts and assumptions could be translated into directors putting plans in place for future Armageddon situations including plans to liquidate assets, restructure debt, reduce or delay expenditure or increase capital to meet the going concern standard.

A requirement for increased committed capital from private equity houses is the key concern the author has for 2009. While the auditors as a profession have been silent on this point to date, rumours abound that private equity houses will be required to provide letters of comfort or further guarantees as to future funding of portfolio companies. Private equity houses will be asked to basically choose up front and in a public document ie the accounts of a company which companies they will support and which they won't and these statements will be relied on by other companies when assessing their own going concern position, particularly where a private equity portfolio company is a major supplier or customer of a third party counterparty. It is important to emphasise that giving letters of comfort or guarantees and the process of getting the auditors to sign off on a going concern can have significant implications on third party trading counter parties. Indeed it is likely that such comfort letters may even be referred to in such counter parties report and accounts.

Accounts are likely to contain in the future significant liquidity and going concern related disclosures and as stated above we are likely to see auditors modifying their reports by adding a paragraph to highlight a “material matter” relating to a company's going concern. This is commonly known as an emphasis of matter paragraph. Auditors will be particularly looking at the following risks, a net liability or current liability position, negative operating cash flow, fixed term borrowings approaching maturity without any 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, the inability to comply with the terms of loan agreements or to pay creditors on due dates or the loss of a major market franchise licence or principal supplier.

The author strongly recommends that all people involved in the preparing of audited accounts for the next financial year read "the Going Concern Issues During the Economic Conditions Bulletin" issued by the Auditing Practicing Board in December 2008, the Financial Reporting Council's booklet "Challenges for Audit Committees Arising out of the Current Economic Conditions" published in November 2008 and the Financial Reporting Council's "An Update for Directors of Listed Companies going concern liquidity risk" also published in November 2008.

Investee directors are going to be put in a very difficult position this year and members of the audit committee of a company are going to have an increased risk of liability to third parties compared to any time in the medium to short term past.

D&O insurance will be key for investee appointed directors .

It is going to be an interesting reporting season and both investee directors, portfolio directors and private equity houses themselves need to take early advice from appropriate professionals to minimise their risk and to identify up front what they will actually be saying in these public documents, namely the report and accounts. Internal controls and risk management systems will be under more scrutiny than at any time since Turnbull and boards will have to come up with analyses of risks facing the business and how those risks are going to be addressed in ever more detail, including unfortunately having to amend long term group strategic plans to reduce any exposure to liquidity risk and counterparty default risk.

Finally, the author has found on several recent occasions that individual companies within a group are not treated internally as individual legal entities. It will be necessary to give full consideration to guarantees, indemnities and liquidity facilities that have been provided to other entities that a company in a group may be called on to honour. This could have implications on trading subsidiaries below holding company structures.

It is likely that it will soon be a requirement of the Financial Reporting Council that disclosures relating to risk are brought together in a single section of a company's annual report or key disclosures are brought together by way of a note including cross references. Is the need to give guarantees and letters of comfort to portfolio companies going to crystallise early restructurings or administrations of portfolio companies?

For once directors liabilities and duties are real - counterparties will be relying on your statements.

Robin Johnson