Testing uncertainty in difficult times

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Headlines proclaim that Britain is emerging from recession and house prices are rising again, but the economic reality for many companies is that times remain tough.

Annual accounts can convey a positive message for some but, for others, accounts and disclosures within them, paint a very different picture. Deterioration in trading and cashflow often lead to working capital deficiencies and unhealthy balance sheet ratios.

So, in such circumstances, what are directors' responsibilities?

Clear guidance is available, in this area, both from accounting standards and a recent publication from the Financial Reporting Council.

- Directors are required to make and, importantly, document rigorous 'going concern' assessment of their company when preparing annual accounts. In making this assessment, the review should cover a period of at least twelve months from approval of the accounts.
- And directors must give balanced, proportionate and clear disclosures regarding 'going concern' to ensure accounts give a true and fair view.

What does this mean in practice?

There is always uncertainty in business but the real issue is whether uncertainties regarding 'going concern' are so fundamental that they require to be disclosed.

For example, in a business with long-term contracts, a history of profitability/cash generation and sufficient banking facilities, there appears to be little uncertainty. But what if a major contract expires in a few months' time and the banking facilities are due for renewal a few months later?

Generally, where such uncertainties exist, directors should be demanding and reviewing projections based on different scenarios to highlight whether there is a potential problem. Although hopes and expectations may be that contracts will be renewed it is essential to consider the implications if they are not:

- How quickly can the business respond?
- What opportunities are there to replace lost business?
- What are the implications for staff?
- What ongoing requirements are there for premises and equipment?

Many companies also have banking covenants which are subject to regular review. Companies with good management information systems generally have up-to-date financial information and budgets for the year ahead. But these need to be tested against differing scenarios so that the board and management have an early warning of potential issues.

With the changes in availability and pricing of credit over the recent past and immediate future, good information is a prerequisite for discussions with lenders regarding financing requirements.

Directors of small companies may think that these requirements don't apply to them

Of course, the extent of the review and work involved will depend on the size and complexity of the business. But the requirements do apply to all regardless of size.

And an early discussion with accountants/auditors will help to establish the nature of the review, evidence required and possible outcomes in terms of disclosures.

This may prompt a discussion with lenders on the renewal of facilities. Indeed, the guidance from the Financial Reporting Council states that

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directors should seek confirmation from lenders over principal terms and conditions where there is a degree of uncertainty.

These discussions may also highlight the best time to sign the accounts, subject to lenders' requirements and filing deadlines. For example, it may be more appropriate to finalise accounts when facilities have been renewed or an asset sold to provide access to new funds. Such events could be disclosed in the accounts, sending a positive message to readers and also protecting directors from making either inadequate disclosures or disclosing uncertainties which have been successfully addressed before the accounts are signed.

To conclude, here are three key questions to be asked:

1. Are you concerned about the implications of assessing going concern for your business?
2. Are you engaging in discussions with your advisers and lenders at the right time?
3. Is appropriate and reliable information available to optimise such discussions?

In any event action and timing thereof is crucial - so in testing times ensure 'going concern' is on the board agenda. ■