



FINANCIAL REPORTING COUNCIL

**AN UPDATE FOR DIRECTORS OF LISTED COMPANIES:
GOING CONCERN AND LIQUIDITY RISK**

NOVEMBER 2008

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One - Introduction

1. Current economic conditions provide particular challenges to all involved with annual reports and accounts. One consequence is expected to be an increase in the disclosures in annual reports and accounts about going concern and liquidity risk. As a result the current conditions will present challenges for all of the parties involved:
 - directors will need to ensure that they prepare thoroughly for their assessment of going concern and make appropriate disclosures;
 - auditors will need to ensure that they fully consider going concern assessments and only refer to going concern in their audit reports when appropriate; and
 - investors and lenders will need to be prepared to read all of the relevant information in annual reports and accounts before making decisions.
2. The purpose of this document is to bring together existing guidance in the context of recent developments relating to going concern and liquidity risk disclosures to assist directors, audit committees and finance teams of listed companies during the forthcoming reporting season. It does not establish any new requirements but it does highlight the importance of clear disclosure about going concern and liquidity risk in current economic conditions. This update may also be useful for directors of unlisted companies who have similar responsibilities to assess going concern and make appropriate disclosures.
3. Going concern is a fundamental accounting concept that underlies the preparation of the annual report and accounts of all UK companies. Under both International Financial Reporting Standards (IFRS) and UK Generally Accepted Accounting Principles (UK GAAP) directors are required to satisfy themselves that it is reasonable for them to conclude that it is appropriate to prepare financial statements on a going concern basis. These requirements are not intended to, and do not, guarantee that a company will remain a going concern until the next annual report and accounts is issued.
4. Both IFRS and UK GAAP require disclosure of the uncertainties that the directors are aware of in making their assessment of going concern where those uncertainties may cast significant doubt on the group's and company's ability to continue as a going concern.
5. The difficult economic conditions being faced by many companies will necessitate careful consideration by directors when assessing whether it is reasonable for them to use the going concern basis of accounting, and whether adequate disclosure has been given of going concern risks and other uncertainties. Addressing these challenges well before the preparation of annual reports and accounts may help avoid a last minute problem that might unsettle investors and lenders unnecessarily.

6. Directors will need to plan their assessment of going concern as early as practicable including deciding on the information and analysis that will need to be produced (such as board papers) and the processes and procedures that will be undertaken. These plans should also address the evidence to be obtained to support their conclusion and develop, where necessary, any remedial action plan.
7. Early discussions with company auditors about these plans may help minimise the risk of last minute surprises, and it may be helpful for a draft of the relevant disclosures about going concern and liquidity risk to be prepared and discussed with the auditors before the end of the financial year.
8. The Financial Reporting Council (FRC) published a consultation document on “Going concern and financial reporting: proposals to revise the guidance for directors of listed companies” (the 2008 Consultation) at the beginning of September 2008. Responses to the 2008 Consultation were due on 24 November 2008. The FRC anticipates that an exposure draft will be issued towards the end of the first quarter next year and will not become effective before mid 2009.
9. The FRC would welcome further feedback on the practical challenges of applying the existing guidance “Going concern and financial reporting: guidance for directors of listed companies registered in the United Kingdom” (the 1994 Guidance), before the end of February 2009.
10. In the meantime the FRC believes that the existing guidance contained in the 1994 Guidance is fit for purpose even in these times of significant economic stress. This guidance can be found on the FRC website at: <http://www.frc.org.uk/corporate/goingconcern.cfm> .
11. The 1994 Guidance indicates that directors may seek confirmation from their bankers regarding the existence and status of their finance arrangements. In the present economic environment bankers may be reluctant to provide positive confirmation that facilities will continue to be available. The absence of confirmations of bank facilities does not of itself necessarily cast significant doubt upon the ability of an entity to continue as a going concern nor necessarily require auditors to refer to going concern in their reports.
12. The effect of current market conditions on individual entities requires careful evaluation. The general economic situation at the present time does not of itself necessarily mean that a material uncertainty exists about a company’s ability to continue as a going concern. However, it is important that annual accounts contain appropriate disclosure of liquidity risk and uncertainties such as are necessary in order to give a true and fair view.
13. Examples illustrating how directors might explain their going concern conclusion taking account of current economic conditions which would facilitate an understanding by readers of annual reports and accounts are included in the appendix to this update.

14. The FRC has recently conducted a study of going concern and liquidity risk disclosures made by companies applying IFRS 7 (Financial instruments: Disclosures) in December 2007 and March 2008 year end annual reports and accounts. The study concluded that there are significant opportunities for improvement by way of better, rather than more, disclosure. In particular, it noted that there was often a significant lack of clarity about how liquidity risk is managed in practice and that much of the relevant information was distributed amongst different parts of annual reports, making it difficult for users to appreciate the full picture.

Two - Accounting requirements with respect to going concern

15. Going concern is a fundamental accounting concept that underlies the preparation of financial statements of all UK companies.
16. Preparing financial statements on a going concern basis is not compatible with the intention or the necessity of a company:
 - entering into a scheme of arrangement with the company's creditors;
 - making an application for an administration order; or
 - being placed into administrative receivership or liquidation.

Assessment of going concern

17. International Accounting Standard (IAS) 1 (Presentation of financial statements) and UK Financial Reporting Standard (FRS) 18 (Accounting policies) require management/directors to make an assessment of an entity's ability to continue as a going concern when preparing financial statements. IAS 1.25 states:

“When preparing financial statements, management shall make an assessment of an entity's ability to continue as a going concern. An entity shall prepare financial statements on a going concern basis unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so. When management is aware, in making its 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, the entity shall disclose those uncertainties.”¹
18. For financial reporting purposes, the assessment of going concern is made at the date that the directors approve the annual report and accounts and takes into account the relevant facts and circumstances at that date. IAS 1.26 also notes that the degree of consideration that may need to be given to the going concern assessment will depend upon the facts of each case.
19. The Listing Rules of the Financial Services Authority also require that the annual reports of listed companies include a statement by the directors that the business is a going concern, together with supporting assumptions or qualifications as necessary, that has been prepared in accordance with the 1994 Guidance.

¹ Similar provision is made by FRS 18 paragraphs 21-25.

20. The Directors statement on going concern is required to be prepared in accordance with the 1994 Guidance which outlines procedures that the directors may wish to adopt in making their assessment. The 1994 Guidance addresses both annual and interim accounts. In relation to the latter directors of listed companies will also need to consider the requirements of IAS 34 (Interim financial reporting).
21. The procedures that are necessary for the directors to comply with the requirements of IAS 1 or FRS 18 are likely to be similar to those adopted to meet their obligations under the Listing Rules. The 1994 Guidance places particular emphasis on the importance of the processes and procedures that directors carry out and highlights some major areas in which procedures are likely to be appropriate, including:
- forecasts and budgets;
 - borrowing requirements;
 - liability management;
 - contingent liabilities;
 - products and markets;
 - financial risk management;
 - other factors; and
 - financial adaptability.
22. The 1994 Guidance notes that this list is not exhaustive and the significance of factors will vary from company to company. In the current economic climate many of these factors will have increased in significance which will require directors to consider them with more rigour and formality.
23. In forming their conclusion on going concern directors will need to evaluate which of three potential outcomes is appropriate to the specific circumstances of the group and company. The directors may conclude:
- there are no material uncertainties that lead to significant doubt upon the entity's ability to continue as a going concern;
 - there are material uncertainties that lead to significant doubt upon the entity's ability to continue as a going concern; or
 - the use of the going concern basis is not appropriate.
24. In addition to the assessment that must be made by directors, auditors are required by auditing standards to determine if, in the auditors' judgment, a material uncertainty exists that may cast significant doubt on the entity's ability to continue as a going concern.

25. Auditing standards provide for a number of different audit reports depending upon the specific facts and circumstances. Auditors may conclude that it is necessary to qualify their opinion, disclaim an opinion, issue an adverse opinion or modify their report by including an emphasis of matter paragraph.
26. Auditors are required to consider the disclosures about going concern and liquidity risk made in the financial statements. If auditors conclude that the disclosures are not adequate to meet the requirements of accounting standards, including the need for financial statements to give a true and fair view, they are required to qualify their opinion and to provide their reasons for doing so. If auditors conclude that a material uncertainty exists that leads to significant doubt about the ability of the entity to continue as a going concern, and those uncertainties have been adequately disclosed in the financial statements, they are required to modify their report by including an emphasis of matter paragraph.
27. The combination of these requirements will generally result in one of the following three outcomes:

Outcome	Consequence for the directors' statement on going concern	Consequence for the auditors' report
No material uncertainties leading to significant doubt about going concern have been identified by the directors.	Disclosure explaining the conclusion on going concern and how that has been reached. <i>Examples 1 and 2 in the attached appendix illustrate this outcome.</i>	Unmodified report (clean) – provided the auditors concur with the directors' assessment and supporting disclosures.
Material uncertainties leading to significant doubt about going concern have been identified by the directors.	Disclosures explaining the specific nature of the material uncertainties and explaining why the going concern basis has still been adopted. <i>Example 3 in the attached appendix illustrates this outcome.</i>	Modified report including an emphasis of matter paragraph highlighting the existence of material uncertainties - provided auditors concur with the directors' assessment and supporting disclosures.
The directors conclude that the going concern basis is not appropriate.	Disclosures explaining the basis of the conclusion and the accounting policies applied in drawing up financial statements on a non-going concern basis.	Unmodified report (clean) – provided that the accounts contain the necessary disclosures and the auditors consider the basis to be appropriate to the specific facts and circumstances.

28. The 1994 Guidance also provides for disclosure when directors conclude that the going concern basis should be used despite having identified factors which cast doubt on the ability of the company to continue in existence for the foreseeable future. Significant changes to disclosure requirements about risks and uncertainties in IFRS, UK GAAP and the Companies Act 2006 (the Act) since 1994 may mean that sufficient disclosure of the factors giving rise to the problem will have been provided through these disclosures (see paragraphs 40 to 49).
29. One impact of current conditions may be to limit finance available from trading counterparties including suppliers, customers and providers of finance. Furthermore, lenders may be more risk averse when considering whether to provide or renew finance facilities and may establish new conditions and these conditions may affect the company and the group and their trading counterparties.
30. In relation to bank and other facilities, paragraphs 30 to 32 of the 1994 Guidance may assist:

30. *The facilities available to the company should be reviewed and compared to the detailed cash flow forecasts for the period to the next balance sheet date, as a minimum. Sensitivity analyses on the critical assumptions should also be used in the comparison. The directors should seek to ensure that there are no anticipated:*

- *shortfalls in facilities against requirements;*
- *arrears of interest; or*
- *breaches of covenants.*

31. *The directors have responsibility to manage borrowing requirements actively. Any potential deficits, arrears or breaches should be discussed with the company's bankers in order to determine whether any action is appropriate. This may prevent potential problems crystallising. The onus is on the directors to be satisfied that there are likely to be appropriate and committed financing arrangements in place.*

32. *The directors may seek confirmation from their bankers regarding the existence and status of any finance arrangements which the company has entered into.*

31. Directors will need to consider carefully the position in the light of the information available to them and the assumptions as to the future availability of finance. Accounting standards do not define what constitutes a 'material uncertainty that may cast significant doubt upon the entity's ability to continue as a going concern'. This involves assessing both the probability of an event occurring and the impact it will have if it does occur. Assessment of these elements may require a high degree of judgment both by the directors, and subsequently by the auditors depending upon individual company and group circumstances.
32. In the present economic environment bankers may be reluctant to provide positive confirmations to the directors that facilities will continue to be available. This reluctance may extend to companies with a profitable business and relatively small borrowing requirements. There may be a number of understandable reasons why a bank may be reluctant to confirm that a facility will be available in the future including:
- the bank responding that in the current economic environment, as a matter of policy, it is not providing such confirmations to its customers;
 - the entity and its bankers are engaged in negotiations about the terms of a facility (e.g. the interest rate), however there is no evidence that the bank is reluctant to lend to the company; and
 - the bank renewed a rolling facility immediately prior to the date of the issuance of the annual report and accounts and is reluctant to go through the administrative burden to confirm that the facility will be renewed again in a year's time.
33. The absence of confirmations of bank facilities does not of itself necessarily cast significant doubt upon the ability of an entity to continue as a going concern nor require necessarily auditors to refer to going concern in their reports.

Three – Going concern review period

34. IFRS contains specific requirements about the period which directors are required to review when assessing going concern. IAS 1.26 provides that management should take into account all available information about the future, which is at least, but not limited to, twelve months from the end of the reporting period.
35. FRS 18 requires disclosure if the period considered by the directors is less than twelve months from the date of approval of the financial statements.
36. Directors should consider the 1994 Guidance which provides that budgets and forecasts should be prepared to cover the period to the next balance sheet date as a minimum and notes that further periods are generally covered by medium or long-term plans which give an indication in general terms of how the directors expect the company to fare. The guidance also notes that the assessment is based on what is known to the directors at the date on which they approve the annual report and accounts which includes events or circumstances of which they are aware that arise after the end of the review period.
37. Where the period considered by the directors has been limited, for example, to a period of less than twelve months from the date of the approval of the annual report and accounts, the directors need to consider whether additional disclosures are necessary to explain adequately the assumptions that underlie the adoption of the going concern basis.
38. Auditing standards also address going concern and the period of the review by the directors. Auditors have an explicit obligation to include an extra paragraph in their audit report if the period covered by the directors' review is less than twelve months from the date of approval of the annual report and accounts and this fact is not disclosed by the directors.

Four - Insolvency

39. Doubts upon the ability of a company to remain a going concern do not necessarily mean that the company is, or is likely to become, insolvent. The solvency of a company is determined by reference to a comparison of its assets and liabilities and by its ability to meet liabilities as they fall due. Where the directors are unable to state that the going concern basis is appropriate, they should consider taking professional advice.

Five - Disclosures relevant to going concern and liquidity risk

Disclosure requirements of the Listing Rules about going concern

40. The Listing Rules require that the annual reports of listed companies include a statement by the directors that the business is a going concern, together with supporting assumptions or qualifications as necessary.
41. The 1994 Guidance notes that if there are doubts as to the appropriateness of the going concern presumption then the annual accounts may need to reflect any relevant factors in greater detail if they are to show a true and fair view. The guidance also notes that when there are factors which, in the event of an unfavourable outcome, cast doubt on the appropriateness of the going concern presumption, the directors should explain the circumstances so as to identify the factors which give rise to the problems (including any external factors outside their control which may affect the outcome) and an explanation of how they intend to deal with the problem so as to resolve it.

Disclosure requirements of IFRS and UK GAAP about going concern and liquidity risk

42. IAS 1 and FRS 18 have explicit disclosure requirements in the event that the directors conclude that there are material uncertainties that may cast significant doubt upon the entity's ability to continue as a going concern. In addition, in recent years there have also been significant changes to specific accounting standards that are relevant to disclosures about liquidity risk and other risks and uncertainties including:

Requirement	IFRS Reference (2008)	UK GAAP (2007/8)
Disclosures relating to risks arising from financial instruments, including liquidity risk where it is material.	IFRS 7 paragraphs 31 to 42	FRS 29 paragraphs 31 to 42
Estimating future cash flows (in connection with impairment of intangible assets).	IAS 36 paragraphs 33 to 54	FRS 11 paragraphs 36 to 40
Disclosure of undrawn borrowing facilities and any restrictions such as covenant requirements, where relevant.	IAS 7 paragraph 50 (a)	No explicit requirement
Disclosure of defaults and covenant breaches and potential reclassification of loans in default as current liabilities.	IAS 1 paragraphs 74 to 76	No explicit requirement
Disclosure of key sources of estimation uncertainty about the carrying amounts of assets and liabilities.	IAS 1 paragraphs 125 to 133	FRS 18 paragraphs 50 to 55

IFRS liquidity risk disclosures

43. Liquidity risk is the risk that an entity will encounter difficulty in meeting its obligations associated with financial liabilities. IFRS 7 (FRS 29) requires an entity to make both qualitative and quantitative disclosures concerning liquidity risk, where it is a material financial risk.
44. Where liquidity risk is material, IFRS 7 (FRS 29) requires:
 - disclosure of information that enables users to evaluate the nature and extent of the entity's exposure to liquidity risk;
 - narrative disclosures explaining how liquidity risk arises in the business and how it is managed in practice;
 - summary numerical data about liquidity risk based on the information that is provided to key management personnel, often the Board of Directors; and
 - certain mandatory disclosures such as a maturity analysis of financial liabilities.
45. The disclosures required by IFRS 7 are supplemented by disclosures required by other IFRS standards. For example, IAS 7 (Statement of cash flows) requires disclosure of undrawn borrowing facilities where relevant to users understanding of the financial position and liquidity of the entity, whilst IAS 1 requires disclosure of defaults and breaches of loan terms and conditions.
46. The current squeeze on corporate cash flows means that liquidity risk is likely to be a material risk this year for many more entities. As a consequence, a greater number of companies are likely to need to present relevant disclosures as required by IFRS 7 (FRS 29), IAS 1, IAS 7 and FRS 18.

Disclosure requirements of the Companies Act 2006 related to Directors' Reports

47. The Act requires the Directors' Report of all companies (except companies subject to the small companies' regime) to include a Business Review.
48. The Business Review is required to be 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. In particular it should include a description of the principal risks and uncertainties facing the company.

49. In the case of a quoted company, the Business Review is also required to provide information on a number of other matters including:
- the main trends and factors likely to affect the future development, performance or position of the company's business; and
 - information about persons with whom the company has contractual or other arrangements which are essential to the business of the company.
50. Directors will need to explain in the Business Review the principal risks and uncertainties facing the company arising from the current difficult economic conditions. One of the purposes of the Business Review is to help the members assess how the directors have performed their duties so it is reasonable to expect that it will also contain an account of how the directors intend to respond to these risks and uncertainties. Issues which may require disclosure depend upon individual facts and circumstances and 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 ;
 - risks arising from current credit arrangements (including the availability of insurance where relevant) with either customers or suppliers;
 - a dependency on key suppliers and customers ; and
 - uncertainties posed by the potential impact of the economic outlook on business activities.
51. The Act also requires auditors to review the Directors' Report and to state in their report whether the information given in the Directors' Report is consistent with the financial statements. Auditing standards provide guidance for auditors on how they should carry out this work.

FRC review of going concern and liquidity risk disclosures

52. The FRC has published a study into going concern and liquidity risk disclosures in the financial statements of listed companies that have adopted IFRS 7. The study can be obtained from the FRC <http://www.frc.org.uk/corporate/goingconcern.cfm>. The study notes that information about going concern and liquidity risk was distributed amongst a number of different parts of the annual report and accounts reviewed, thus making it difficult for users to determine and evaluate the extent to which liquidity concerns were relevant to the business and how liquidity risk was being managed in practice.
53. The study concluded that it would be particularly helpful if all of these disclosures could be brought together into a single section of a company's annual reports and accounts.

54. If it is not practical to provide the information in a single section, the study recommends that the key disclosures be brought together by way of a note including cross references to help readers of annual reports and accounts to find all of the relevant pieces of information.
55. It would be useful if such a note included the following components:
- Paragraph 1 explaining cash and borrowing positions and how liquidity risk is managed in practice.
 - Paragraph 2 explaining whether confirmation of the renewal of banking and other facilities has been sought and if so whether those confirmations have been obtained².
 - Paragraph 3 stating that the use of the going concern basis of accounting is appropriate and explaining the basis of that conclusion.
56. Examples illustrating these disclosures are included in the appendix to this update.
57. The FRC study also concluded that, while in general information about cash balances, borrowings and facilities was provided on a comprehensive basis, the level of detail about how liquidity risk was managed in practice and the information used by key management to monitor liquidity risk varied greatly. In particular:
- For many companies, the disclosures were generic rather than specific in nature. Only a minority of companies provided information that shed light on how the business managed its day to day cash flow and borrowing levels.
 - A conclusion could not be reached on whether appropriate disclosure had been made of summarised data about liquidity risk as provided to key management personnel (generally the directors). Reaching such a conclusion would have required access to internal company documentation.

² See paragraphs 29 to 33.

Six - Preliminary announcements

58. Preliminary announcements of annual results form one of the focal points for investor interest, primarily because they confirm or update market expectations. Under the Listing Rules such announcements are voluntary, although if made their contents are subject to minimum requirements. Where a company chooses to publish a preliminary announcement the directors are required by the Listing Rules to have agreed the preliminary announcement with their auditor prior to publication.
59. The Listing Rules provide that, if a preliminary announcement is made, it should give details of the nature of any likely modification that may be contained in the auditor's report required to be included with the annual report and accounts. Modified audit reports encompass audit reports that:
- are qualified;
 - express an adverse opinion;
 - express a disclaimer of opinion; or
 - contain an emphasis of matter paragraph (including a paragraph highlighting a material matter regarding a going concern problem).

Appendix – examples of going concern disclosures

The purpose of this appendix is merely to illustrate the principles in paragraph 55 in bringing together going concern and liquidity risk disclosures. In practice such disclosures should be specific to the individual circumstances of each company.

Example 1 – A group with significant positive bank balances, uncomplicated circumstances and little or no exposure to uncertainties in the current economic environment which may impact the going concern assumption.

The group's business activities, together with the factors likely to affect its future development, performance and position are set out in the Business Review on pages X to Y. The financial position of the group, its cash flows, liquidity position and borrowing facilities are described in the Chief Financial Officer's Review on pages P to Q. In addition note A to the financial statements includes the group's objectives, policies and processes for managing its capital; its financial risk management objectives; details of its financial instruments and hedging activities; and its exposures to credit risk and liquidity risk.

The group has considerable financial resources together with long-term contracts with a number of customers and suppliers across different geographic areas and industries. As a consequence, the directors believe that the group is well placed to manage its business risks successfully despite the current uncertain economic outlook.

After making enquiries, the directors have a reasonable expectation that the company and the group have adequate resources to continue in operational existence for the foreseeable future. Accordingly, they continue to adopt the going concern basis in preparing the annual report and accounts.

Example 2 – A group with uncomplicated circumstances, some exposure to the current economic uncertainties and either a current material bank overdraft or loan and a need to renew this facility in the foreseeable future albeit not imminently.

Paragraph similar to example 1, paragraph 1.

As highlighted in note B to the financial statements, the group meets its day to day working capital requirements through an overdraft facility which is due for renewal on [date]. The current economic conditions create uncertainty particularly over (a) the level of demand for the group's products; (b) the exchange rate between sterling and currency X and thus the consequence for the cost of the group's raw materials; and (c) the availability of bank finance in the foreseeable future.

The group's forecasts and projections, taking account of reasonably possible changes in trading performance, show that the group should be able to operate within the level of its current facility. The group will open renewal negotiations with the bank in due course and has at this stage not sought any written commitment that the facility will be renewed. However, the group has held discussion with its bankers about its future borrowing needs and no matters have been drawn to its attention to suggest that renewal may not be forthcoming on acceptable terms.

Paragraph as per example 1, paragraph 3.

Example 3 - A group with complicated circumstances, considerable exposure to the current economic uncertainties and either a current material bank overdraft or loan which requires renewal and perhaps an increase in the year ahead.

Paragraph as example 1, paragraph 1.

As described in the directors' report on page X the current economic environment is challenging and the group has reported an operating loss for the year. The directors' consider that the outlook presents significant challenges in terms of sales volume and pricing as well as input costs. Whilst the directors have instituted measures to preserve cash and secure additional finance, these circumstances create material uncertainties over future trading results and cash flows.

As explained on page X, the directors are seeking to sell a property to provide additional working capital. The group is in negotiations with a potential purchaser but there can be no certainty that a sale will proceed. Based on negotiations conducted to date the directors have a reasonable expectation that it will proceed successfully, but if not the group will need to secure additional finance facilities.

As explained in the Business Review on Page Y, the group's has commenced discussions with its bankers about an additional facility that may prove to be necessary should the sale of the property not proceed or should material adverse changes in sales volumes or margins occur. It is likely that these discussions will not be completed for some time. The directors are also pursuing alternative sources of funding in case an additional facility is not forthcoming, but have not yet secured a commitment.

The directors have concluded that the combination of these circumstances represent a material uncertainty that casts significant doubt upon the group's and the company's ability to continue as a going concern. Nevertheless after making enquiries, and considering the uncertainties described above, the directors have a reasonable expectation that the group and the company have adequate resources to continue in operational existence for the foreseeable future. For these reasons, they continue to adopt the going concern basis in preparing the annual report and accounts.

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