



**FINANCIAL REPORTING COUNCIL**

**CHALLENGES FOR AUDIT COMMITTEES  
ARISING FROM CURRENT ECONOMIC CONDITIONS**

**NOVEMBER 2008**



## Introduction

Current economic conditions provide particular challenges to all involved with annual reports and accounts. The purpose of this document is to assist audit committees by identifying key questions that they may need to consider when preparing for the year end and in carrying out their role in relation to annual financial statements. It does not establish any new requirements.

The Financial Reporting Council (FRC) has also published “An update for directors for directors of listed companies: going concern and liquidity risk” which brings together the existing guidance and recent developments relating to going concern and liquidity risk which may usefully be read in conjunction with this document. (<http://www.frc.org.uk/corporate/goingconcern.cfm>)

### *Requirements of the combined code and related guidance*

The FRC is responsible for the Combined Code on Corporate Governance (the Code) and its associated Guidance on internal control (the Turnbull Guidance), Guidance on audit committees, and on Going concern and financial reporting.

Principle C.1 of the Code sets out that the board should present a balanced and understandable assessment of the company’s position and prospects. Further, the board is responsible for the preparation of financial statements that give a true and fair view. Principle C.3 sets out that board’s should establish formal and transparent arrangements for considering how they should apply the financial reporting and internal control principles and for maintaining an appropriate relationship with the company’s auditors, and provision C.3.1 of the code envisages that boards should establish an audit committee.

The Guidance on audit committees sets out the main role and responsibilities of an audit committee. Particularly relevant in current economic conditions is monitoring the integrity of the financial statements of the company and any formal announcements relating to the company’s financial performance, reviewing significant judgments contained in them, and reviewing the company’s system of internal financial controls and internal controls and risk management systems. The attached questions seek to address issues that will be relevant to the work of many audit committees over the next few months.

## **Key issues for audit committees to consider when preparing for year end processes and reports**

### ***Year end planning considerations***

Business risks have changed considerably in recent months. The financial crisis has led to stress in the non-financial parts of the economy. The update for directors on going concern and liquidity risk emphasises the benefit of planning how to address the going concern assessment as early as practicable. Audit committees may need to reconsider the risks that their business faces and to ensure that they have considered the impact of these new risks on their work in advance of the annual reporting season. They are also likely to want to be satisfied that appropriate plans for the assessment of going concern have been made.

Effective systems are particularly vital at times of economic stress, in order to react to fast-changing markets and to help manage an increased risk of error, omission and fraud when management and supporting finance teams are under abnormal pressures. Audit committees may wish to reconfirm that reporting and internal control systems are in place and functioning effectively and that resources are in place to support and audit difficult year-end judgments.

### ***Liquidity risk and going concern***

Some companies are facing additional difficulties securing finance and some are reported to have experienced reduced facilities, increased cost and/or more demanding covenants. These trends are likely to continue.

Heightened liquidity risk may necessitate greater attention to the key assumptions and processes that lead to cash flow forecasts. In some cases, detailed consideration will need to be given to determine whether there are, or are not, material uncertainties leading to significant doubt about whether the business is a going concern. Audit committees are likely to examine in more detail the rigour with which the analysis supporting the going concern judgment has been made and the integrity of the disclosures about going concern in the financial statements and other market communications.

### ***Reliance on assumptions and models for cash flow and valuation information***

The volatile market conditions mean that many companies will need to consider a wider range of reasonably possible outcomes when performing sensitivity analysis on their cash flow projections that support asset valuations and asset impairment assessments.

This increase in the range of reasonably possible outcomes faced by businesses introduces significant additional pressure on the judgments needed to evaluate illiquid asset values. In view of the continuing volatility of financial and non-financial markets, audit committees are likely to want a better understanding of these judgments and are likely to require more detailed analysis and supporting information than in previous years.

*Significant accounting and reporting judgments*

Principles based accounting and reporting standards depend upon them being applied in a constructive and transparent manner with a focus on useful communications, not just the minimum necessary to comply with laws and regulations. At times of stress, audit committees are likely to want to be assured that key judgments are supported by a greater degree of rigour and analysis than in more normal circumstances.

The following schedule sets out in more detail potential key questions that may be relevant to audit committees as they seek to address these challenges. The importance of the different questions will vary depending upon individual facts and circumstances.

November 2008

## 2008/09 Corporate Reports Key Questions for Audit Committees

Area of consideration	Key questions
<i>Year-end planning considerations</i>	<p>Has the audit committee considered how it should respond to a heightened risk of errors, omissions or manipulation of reported financial results or balance sheet presentation? Has it assessed how these risks have been mitigated or does it have plans in place to do so?</p> <p>Does the committee need to add to its membership or bring in specialist advisers to help it to meet its responsibilities? If so, have the additional resources been secured?</p> <p>Does the committee need further analysis of the risks facing the business and how those risks are being addressed? If this is necessary, has the analysis been commissioned and a deadline agreed?</p> <p>Is the committee satisfied that the board has responded effectively to business risks which have developed over the year with appropriate modifications to the group's strategy? If this is in progress, is there an agreed timetable to report back to the committee?</p> <p>Has a recent review been conducted of reporting arrangements to ensure that high-quality, well-controlled and timely management data is available? Did that review conclude that additional resources, controls or procedures were necessary and, if so, is there a date to report progress to the committee?</p> <p>Has the committee considered whether the group finance function needs additional specialist skills, experience or resources to prepare the annual report and supporting year-end information for the board and the committee? If additional resources are required, has a plan to increase resources been made and implemented?</p> <p>Has the committee considered whether the group reporting timetable has adequate time for all issues to be properly addressed and is there sufficient flexibility to be able to cope with unexpected events?</p> <p>Has the committee recently reviewed the principal group accounting policies? Did that review consider all areas that may have been impacted by changing economic conditions and events? Is there a need to schedule an update before the year end?</p>

## 2008/09 Corporate Reports Key Questions for Audit Committees

	<p>Has the committee considered whether the group audit plan has been updated to address current risks? Have the external auditors allocated sufficient additional and experienced resources to address heightened risks and, if not, are negotiations scheduled to secure additional commitments?</p> <p>Is the committee satisfied that appropriate plans are in place to make a considered assessment about the use of the going concern basis of accounting at the date of approval of the annual report and accounts, and that any necessary remedial action has been identified?</p> <p>Where an internal audit function exists, has the committee considered whether it wishes internal audit to conduct additional work up to or at the year end and if so, are arrangements in place to ensure that the work is completed and reports made available on a timely basis?</p> <p>Will the audit committee need additional information to enable it to complete its work at the year end, and if so have arrangements been made for this to be provided on a timely basis?</p>
<p><i>Liquidity risk and going concern</i></p>	<p>Has the audit committee considered whether the board may need to amend the group strategic plan including expectations of future growth and the group's ability to sustain its business model? Has the group monitored its position in relation to continued volatility in the financial markets, including its exposure to liquidity risk and counterparty default risk?</p> <p>Is the committee satisfied by the process that the board has conducted to conclude that the financial statements should be prepared on a going concern basis? Was reference made to "Going Concern and Financial Reporting: Guidance for directors of listed companies November 1994".</p> <p>Is the committee satisfied that proper consideration has been given to cash flow forecasts prepared for at least, but not limited to, twelve months from the balance sheet date including an analysis of headroom against available facilities? Has the committee considered whether there is a need to extend the cash flow forecast exercise to evaluate issues that may arise after the end of the period covered by cash flow forecasts?</p> <p>Is the committee satisfied that appropriate evidence has been obtained about the group's ability to secure new or to renew funding commitments? Is additional evidence needed about the intentions of investors and lenders?</p>

## 2008/09 Corporate Reports Key Questions for Audit Committees

	<p>Has the committee considered an analysis of the terms of current banking facilities and covenants, and has this analysis identified risks that need to be addressed? If so, are plans in place to manage those risks?</p> <p>Is the committee satisfied that full consideration has been given to guarantees, indemnities or liquidity facilities that have been provided to other entities that the group may be called on to honour? Have the directors considered whether the group has the resources to meet such obligations should they arise?</p>
<p><i>Reliance on models for cash flow and valuation information</i></p>	<p>Has the audit committee considered the processes in place to ensure that appropriate procedures and controls have been applied to the group's use of models to generate cash flow and valuation information, including the choice and consistent use of key assumptions?</p> <p>Is the audit committee satisfied that key models have been subject to independent analysis and verification, for example by internal audit?</p> <p>Is the audit committee satisfied that appropriate sensitivity analysis has been conducted to flex assumptions to identify how robust the model outputs are in practice and that the assumptions are free from bias? Is it clear that the sensitivity analysis has considered appropriately the potential impact of reasonably possible events? For example, have relationships with third parties including suppliers and customers been reviewed in the light of recent events and has the potential for third party defaults been taken into account?</p> <p>Where assets are not traded, perhaps because markets are no longer active, has the committee satisfied itself that appropriate additional procedures have been undertaken to estimate fair values through the selection of market-based variables and the use of appropriate assumptions?</p> <p>Where models have been used to estimate the value of assets which must be tested for impairment, is the committee satisfied by the procedures adopted to estimate cash flows and the appropriate adjustments made for risk?</p>



## 2008/09 Corporate Reports Key Questions for Audit Committees

<i>Significant accounting and reporting judgments</i>	<p>Is the audit committee satisfied that appropriate and balanced disclosures have been made about going concern and liquidity risk that draw on the specific circumstances of the company and the group?</p> <p>Is the audit committee satisfied that the business review presents the principal risks and uncertainties associated with the group's activities in a fair and transparent way? Has unnecessary clutter been removed and generic comment been kept to a minimum so that the key messages have not been obscured?</p> <p>Has the committee considered whether the group's business review adequately addresses the additional requirements introduced by recent revisions to the business review requirements of the Companies Act? For example, disclosure is now required of the main trends likely to affect future business development. Is the committee satisfied that the business review is consistent with the rest of the annual report?</p> <p>Is the committee satisfied that appropriate disclosure has been made of write offs and potential write offs of goodwill or individual assets impacted by current events, including information about key assumptions and sensitivity analysis? Has the committee considered whether any identified impairments could be either insufficient or excessive?</p> <p>Has the committee considered whether the audited financial statements describe all of the key judgments about the application of accounting policies and the estimation uncertainties that could result in material losses in the next year? In particular, have all relevant issues that have concerned management during the year and that have been drawn to the attention of the board and/or the audit committee been considered for disclosure?</p> <p>Is the committee satisfied that full consideration has been given to post balance sheet events up to the date of approval of the annual report and accounts? Are there any significant adverse trends in cash flows or asset values or off-balance sheet arrangements that may need special mention?</p> <p>Has the committee considered whether there is a need for additional disclosures about company circumstances in preliminary announcements or other regulatory reports before the annual report is published? For example, early disclosure may need to be considered when directors first conclude that significant doubts exist about going concern.</p>
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Registered Office: 5th Floor, Aldwych House, 71-91 Aldwych, London WC2B 4HN.



**FINANCIAL REPORTING COUNCIL**  
**5TH FLOOR**  
**ALDWYCH HOUSE**  
**71-91 ALDWYCH**  
**LONDON WC2B 4HN**  
**TEL: +44 (0)20 7492 2300**  
**FAX: +44 (0)20 7492 2301**  
**WEBSITE: [www.frc.org.uk](http://www.frc.org.uk)**