

GOING CONCERN

one year on: How to prepare for the auditors



▶ **THE DECEMBER 2008 YEAR END LED TO MANY DIRECTORS OF INVESTMENT PROPERTY COMPANIES HAVING PREVIOUSLY UNCHARTERED DISCUSSIONS WITH THEIR AUDITORS. PHRASES SUCH AS "GOING CONCERN" AND "EMPHASIS OF MATTER" BECAME COMMON PLACE. AUDITORS WERE ASKING QUESTIONS AND REQUESTING INFORMATION ABOUT AN ENTITY'S ABILITY TO CONTINUE AS A GOING CONCERN AT A LEVEL NOT SEEN IN MANY YEARS.**

One year on, market conditions have eased slightly. Yields on prime properties at least are hardening, activity in the market has increased and there is a little more liquidity in the market. However, going concern will again be at the forefront of the auditor's mind. So what are the key learning points and what can directors do to ease the process this time round?

An auditor's focus will be on two key areas: the availability of bank finance and forecast cash flows. When looking at the availability of bank finance, the auditor will want to know, among other factors:

- What is the length of the facility term?
- How likely are facilities to be renewed which expire in the going concern period?
- What evidence is there that the facilities are likely to be renewed?
- What covenants are in place?
- Can the covenants be satisfied both at the year-end and during the going concern period?

FOCUS ON COVENANT BREACHES

Throughout the credit crunch, lenders have shown themselves to be prepared to either ignore loan to value covenant ("LTV") breaches or more commonly use them as an excuse to charge a higher fee or margin. To date, there has not been an appetite from the banks to enforce their rights over the property on a LTV breach.

Income covenant breaches are a different situation altogether. If an entity is failing to service its debt, the banks have shown a greater willingness to take control of the property and either crystallise a loss immediately through a distressed sale or try and achieve a workout with a new management team.

Void rates are increasing and rental income growth is down 9.9 per cent on November 2008 according to CBRE's all property index. Research from BDO's own Industry Watch publication shows that business failures are expected to peak at 33,000 in 2009 and remain flat at 32,700 in 2010. It is actual or potential future income covenant breaches that will be concerning auditors this year. There will be an increased focus on the strength of tenant covenants and sensitivity and stress testing of the projected income flows.

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REVIEW CASH FLOW FORECASTS

Cash flow forecasts need a challenging review and auditors will consider historical trends and expectations, sensitivities applied by management, reliance on key tenants, headroom and consistency with the current position.

Going Concern and Liquidity Risk: Guidance for Directors of UK Companies 2009 was published by the Financial Reporting Council in October 2009 and is effective for periods ending on or after 31 December 2009. The Guidance is based on three principles covering the process which directors should follow when assessing going concern; the period covered by the assessment, the disclosures on going concern and, liquidity risk. The publication includes detailed guidance on sensitivity analysis and stress testing stating that: "sensitivity analysis should be prepared to enable an understanding to be gained of the critical assumptions that underlie the budgets and forecasts."

Where sensitivity analysis indicates that there is a significant risk that the headroom between cash requirements and facilities available will be insufficient, the company should stress test its assumptions. Stress testing enables the directors to assess the effect of a combination of pessimistic, but plausible estimates or assumptions. The main cash flows for investment property companies tend to be contracted, therefore making forecasting an easier exercise than for entities from other sectors. The use of fixed rate interest rate swaps means that often the main area of uncertainty for auditors (and directors) is the rental income flow.

Auditors will want to understand who your tenants are and how long their lease agreements are for. If a lease agreement is reaching its end, be prepared to share information with the auditors as to the prospects for the building going forward. Auditors will want to see third-party evidence that gives them comfort over any negotiations with prospective tenants.

Finally, directors should remember that a breach, even if rectified, can dramatically impact the presentation of the related liabilities in your financial statements. Accounting standards require liabilities to be classified as short term (falling due within one year) or long term (falling due after one year) according to the conditions that exist at the balance sheet date. Where a breach of covenant occurs which makes the liabilities potentially repayable on demand, the related liabilities, which might otherwise fall due after more than one year, will usually need to be disclosed in the financial statements as current liabilities. However, provided a suitable written waiver of the breach is obtained pre year end, then it should be possible for the related liability to continue to be classified as a long term liability.

ACT EARLY

If there is uncertainty over the ability of your BDO company to continue as a going concern, do not hide from the issue. Early communication with your auditor (and potentially other stakeholders) is key to identifying the issues and understanding what needs to be done. If there are issues, it is important to be able to demonstrate to your auditor the steps you have taken to address these and why your company will continue to trade in the years to come.

For more information on how BDO can help you please contact **Michael Goldstein** on **020 7893 3529** or email **michael.goldstein@bdo.co.uk** or contact your local BDO adviser.

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