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Disclosure in financial reports[1] on the going concern assumption, financial risks, tests of assets for impairment and uncertainties in the use of estimations

Introduction

The difficult economic and market conditions engendered by the severe financial and economic crisis take on special importance in the preparation of the next financial reports and make it incumbent on all those involved in that process in various capacities (members of the management and control bodies and managers in charge) to think carefully about the information that must be provided in such documents as a whole.

In particular, users of financial information (for example, analysts, investors and the financial press) have high expectations regarding the ability of the forthcoming financial statements to provide a clear, complete and transparent picture of the different risks that companies face today and of the uncertainties they may encounter in the course of operations.

It is therefore indispensable, in the present conditions of the market, to draw the attention of the management and control bodies and managers in charge to the need to ensure disclosure that makes clear the effects of the crisis on the company's profits and losses, assets and liabilities and financial position, its operating and strategic decisions and any adjustments made to adapt its strategy to the altered environment. Suitable transparency of information can help to reduce uncertainty and its adverse effects.

In general, the three Authorities consider the legislation on financial statements and the provisions of the International Accounting Standards adequate for an effective response to the market's needs for information. Precise and full compliance with them is thus essential in the current environment.

This document does not have prescriptive content of its own, for it does not introduce any additional requirement, but reminds all those who take part in preparing financial reports of the need for precise and complete application of the relevant accounting rules and standards as a whole.

[1] In this document "financial reports" means annual and half-yearly financial statements.

In the discussion among market participants, the aspects that have received special attention and that will presumably be affected most strongly by the current crisis conditions are: (i) the application of the going concern assumption, (ii) the description of the systems for measuring and managing financial risks and the degree of exposure to such risks, (iii) tests for impairment of assets, and (iv) estimation uncertainty.

A. <u>Preparation of the financial statements on a going concern basis</u>

The current conditions of the financial markets and the real economy require that especially accurate assessment be made of whether the going concern assumption is appropriate.

Paragraph 13 of IAS 1 establishes that:[2] "*Financial statements shall present fairly the financial position, financial performance and cash flows of an entity. Fair presentation requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition for assets, liabilities, income and expenses set out in the Framework. The application of IFRSs, with additional disclosure when necessary, is presumed to result in financial statements that achieve a fair presentation.*"

Paragraphs 23-24 of IAS 1 lay down that:

"*When preparing financial statements, management shall make an assessment of an entity's ability to continue as a going concern. Financial statements shall be prepared 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, those uncertainties shall be disclosed. When financial statements are not prepared on a going concern basis, that fact shall be disclosed, together with the basis on which the financial statements are prepared and the reason why the entity is not regarded as a going concern.*

"*In assessing whether the going concern assumption is appropriate, management takes into account all available information about the future, which is at least, but is not limited to, 12 months from the balance sheet date. The degree of consideration depends on the facts in each case. When an entity has a history of profitable operations and ready access to financial resources, a conclusion that the going concern basis of accounting is appropriate may be reached without detailed analysis. In other cases, management may need to consider a wide range of factors relating to current and expected profitability, debt repayment schedules and potential sources of replacement financing before it can satisfy itself that the going concern basis is appropriate.*"

Regarding the need to disclose any material uncertainties in preparing the financial statements, it is advisable also to take account of Article 2428 of the Civil Code, which

[2] In this document reference is made to the International Accounting Standards adopted with European Commission Regulation 1126/2008.

lays down that the report on operations must contain a description of the main risks and uncertainties to which the company is exposed.[3]

Notion of going concern

The notion of going concern implies that the company will continue in operational existence in the foreseeable future. The preparation of financial statements on a going concern basis is incompatible with the intention or need to liquidate the entity or to cease trading.

Notion of foreseeable future

IAS 1 contains specific provisions concerning the period that management must consider in assessing whether the going concern assumption is appropriate. In particular, paragraph 2 lays down that management must take account of all available information about the future, which is at least, but is not limited to, 12 months from the balance sheet date. The degree of analysis depends on the specific circumstances of each company. In some cases, "*management may need to consider a wide range of factors relating to current and expected profitability, debt repayment schedules and potential sources of replacement financing before it can satisfy itself that the going concern basis is appropriate*" (IAS 1, paragraph 24).

In every case, management's assessment of the going concern assumption involves the formulation of a judgment, at a given time, on the future outcome of events or conditions that by their nature are uncertain.

Events or conditions that may cast significant doubt on the going concern condition

As cited, paragraph 24 of IAS requires that management consider all the factors and circumstances that may be relevant to assessing whether the going concern condition is met. Some indicators can be especially significant in the current economic environment.

A list of examples of such indicators was prepared in drafting International Standard on Auditing 570 "Going Concern".[4] Within the realm of their professional responsibility, auditors are in fact required to assess appropriate utilization of the going concern assumption and to consider whether there are material uncertainties concerning this assumption that must be disclosed in the financial statements.

The indicators listed in paragraph 8 of International Standard of Auditing 570 "Going Concern" are shown below:

Financial indicators

- net liability or net current liability position;

[3] These same considerations apply to banks and financial intermediaries on the one hand and to insurance companies on the other, required to draw up a report on operations pursuant to, respectively, Article 3 of Legislative Decree 87/1992 and Articles 94 and 100 of Legislative Decree 209/2005.
[4] International Standard on Auditing 570 "Going Concern", recommended by Consob with Resolution 16231 of 21 November 2007.

- fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets;
- indications of withdrawal of financial support by creditors;
- negative operating cash flows indicated by historical or prospective financial statements;
- adverse key financial ratios;
- substantial operating losses or significant deterioration in the value of assets used to generate cash flows;
- arrears or discontinuance of dividends;
- inability to pay creditors on due dates;
- inability to comply with the terms of loan agreements;
- change from credit to cash-on-delivery transactions with suppliers;
- inability to obtain financing for essential new product development or other essential investments.

Operating indicators

- loss of key management without replacement;
- loss of a major market, franchise, licence or principal supplier;
- labour difficulties or shortages of important supplies.

Other indicators

- non-compliance with capital or other statutory requirements;
- pending legal or regulatory proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy;
- changes in legislation or government policy expected to adversely affect the entity.

The Document of the International Auditing and Assurance Standards Board (IAASB), "Audit Consideration in Respect of Going Concern in the Current Economic Environment" of 20 January 2009[5] highlights, among the above indicators, those that presumably will appear most frequently in the current market environment. In addition, it underscores the need to frame assessments of the going concern prospect in the economic context in which the company operates, taking account not only of adverse micro and macroeconomic factors, but also of possible governmental economic support measures.

Lastly, the IAASB document provides some indications regarding the elements to consider in identifying material uncertainties that may cast doubt on the appropriateness of the going concern assumption. In the absence of specific definitions in IAS 1, these indications can also serve as a point of reference for the preparation of financial statements.

[5] Available at http://web.ifac.org/download/IAASB_Staff_Audit_Practice_Alerts_2009_01.pdf.

Disclosure on the assessments concerning the going concern assumption

Article 2428 of the Civil Code, Article 3 of Legislative Decree 87/1992 and Articles 94 and 100 of Legislative Decree 209/2005 require that management's report on operations provide a description of the main risks and uncertainties to which the company is exposed.

Paragraph 24 of IAS 1 specifies that when a company has a history of profitable operations and ready access to financial resources, a conclusion that the going concern basis of accounting is appropriate may be reached without detailed analysis. However, this approach may no longer be valid in the current economic and financial environment. Problems relating to liquidity risk and credit risk can create fresh uncertainties and heighten existing ones. This situation calls for greater attention than in the past in assessing the going concern assumption.

Where management is of the view that, although use of the going concern assumption is appropriate, uncertainties nevertheless exist that can give rise to significant doubts about the company's ability to continue its operations on a going concern basis, such uncertainties and the associated significant doubts must be disclosed as such in the notes to the financial statements, in accordance with IAS 1, paragraph 23.

In order to enhance the clarity of financial reports, the information concerning the going concern assumption should be provided in a single section, preferably that on accounting policies. Where this is not possible, appropriate references should be made to the parts of the document in which this information is provided.

Concerning the substance of the information on the going concern assumption, at the end of the examination the directors may find themselves faced with three scenarios:

1. they have a reasonable expectation that the company will continue in operational existence in the foreseeable future and have prepared the financial statements on the basis of the going concern assumption. Any uncertainties found are not significant and do not cast doubt on the going concern assumption (scenario 1);

2. they have identified factors that may give rise to significant doubts about the company's ability to continue in operational existence in the foreseeable future, but they nevertheless consider it appropriate to use the going concern assumption in drawing up the financial statements (scenario 2);

3. they consider it unlikely that the company will continue its operational existence in the foreseeable future and do not deem it appropriate to draw up the financial statements on the basis of the going concern assumption (scenario 3).

In scenario 1, where uncertainties are found, they are to be described in the report on operations, together with the events and conditions that led the directors to consider them surmountable and the going concern assumption condition satisfied.

In scenario 2, in the first place attention is called to the need for the notes explicitly to indicate that material uncertainties were found that cast significant doubt on the going concern assumption. In addition, there must be an adequate description of the origin and nature of these uncertainties and of the arguments supporting the decision nevertheless to prepare the financial statements on the basis of the going concern assumption.

Adequate disclosure cannot fail to mention the steps that the company has taken or is taking (for example, plans for debt restructuring, capital strengthening, cost reduction, asset sales, etc.) in order to cope with the effects of these uncertainties on going concern. Furthermore, the directors must adequately describe the arguments supporting the reasonableness of these measures. Only through effectively transparent disclosure on this matter will it be possible to evaluate the reasonableness of the final decision concerning the adoption of the going concern assumption.

In scenario 3, it will be necessary to offer a clear and complete description of the conclusions reached and the accounting policies adopted in preparing the financial statements in the absence of the going concern assumption.

For purely illustrative purposes, Annex 1 gives two examples, based on the Financial Reporting Council's document "An Update for Directors of Listed Companies: Going Concern and Liquidity Risk",[6] of how disclosure can be made of the assessments underlying the application of the going concern assumption for:

scenario 1: a company that has modest exposure to the uncertainties of the economic environment, such as not to cast significant doubt on the going concern assumption. Such disclosure is generally provided in the report on operations (Example 1);

scenario 2: a company that has significant exposure to the uncertainties of the economic environment (for example, complex financial conditions, high bank debt, etc.), such as to cast significant doubt on the going concern assumption. Such disclosure must be made in the notes to the financial statements (Example 2).

B. Disclosure on financial risks

The financial turbulence triggered by the US subprime mortgage crisis and the slowdown of the real economy in many countries can create difficulties for companies in obtaining fresh financial resources, fully realizing the value of their financial exposures and complying with the terms and conditions of outstanding debt contracts. In addition, there has been an increase in exposure to market risks connected with the volatility of the financial variables.

International Financial Reporting Standard 7: *Financial instruments disclosures* requires disclosures on the nature and extent of the financial risks to which the company is exposed.

In particular, financial reports must contain disclosures that make it possible to assess the significance of the financial instruments in relation to the balance sheet and financial position and financial performance of the company and the nature and extent of risks arising from financial instruments to which the company is exposed during the accounting period and at the reporting date, and how the company manages those risks

[6] Available at http://www.frc.org.uk/publications/pub1784.html.

(IFRS 7, paragraph 1). As a rule, the risks involved are credit risk, liquidity risk and market risks (IFRS 7, paragraphs 33-42).

In view of the problems that can arise in the present macroeconomic environment, attention is drawn to the need to provide the information required by IFRS 7 in a complete and exhaustive manner, so that, through a combination of qualitative and quantitative data, users of the financial statements are given a clear picture of the systems adopted by the company to manage, measure and control financial risks and of the extent of such risks.

The changes in the exposure to financial risks with respect to the previous reporting period (IFRS 7, paragraph 33(c)) are also relevant for the purposes of providing adequate information regarding the impact of the current economic and financial environment.

In the current convulsed state of the financial markets it is especially important for financial reports to provide adequate disclosure on liquidity risk.[7] Accordingly, and in conformity with IFRS 7, companies are required to provide in the notes to the financial statements both qualitative disclosures (exposures, how they arise, the company's objectives, policies and processes for managing liquidity risk and the methods used to measure it) and quantitative disclosures. In particular, in indicating the contractual cash flows in undiscounted form, companies must determine both an appropriate number of maturity time bands and the width of these bands, according to the significance standard (IFRS 7, paragraph 39(a) and paragraphs B11-B16).Where liquidity risk is significant, the directors must describe how the company manages the risk. If steps that have been taken or will be taken to face this risk are mentioned in other parts of the financial statements, they must be cross-referenced.

In addition to providing the disclosures envisaged by IFRS 7 and by the regulations issued by the Bank of Italy, banks and supervised financial intermediaries, considering the particular nature of their operations, will assess the advisability of providing additional data if necessary to make the presentation of this risk profile still clearer.

With regard to risk concentration, it is noted here that for industrial firms trade credit is of special importance. Above and beyond the provisions concerning exposure to credit risk, possible risks of concentration vis-à-vis individual counterparties or categories of customer that may prove significant should be disclosed.

With specific reference to intermediaries, reference is made to the recommendation, made by the Financial Stability Forum in its Report of 7 April 2008,[8] to provide ample and detailed disclosure concerning, in particular, exposure to financial products that the market considers to be high-risk. Annex B to the Report summarizes the disclosures deemed most useful for this purpose, which are based on the leading-practice disclosures of a sample of major banks and financial intermediaries at international

[7] This is attested to by the attention such disclosure receives in international discussion. The IASB has proposed amendments to IFRS 7 in order to improve disclosures on liquidity risk.
[8] Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience, available on the FSF's website at http://www.fsforum.org/publications/r_0804.pdf as well as on the Bank of Italy's website (http://www://bancaditalia.it) both in the original English version and in an Italian translation prepared by the Bank of Italy

level.[9] The FSF Report recommends reporting the total exposure for each class/type of financial instrument, including positions held by off-balance-sheet special purpose entities, and the related amounts, before and after hedging, gross and net of write-downs. The extent and detail of disclosure must be commensurate with the importance that the exposures in question have with respect to the intermediary's overall operations or with the extent of the risks borne by the intermediary. The absence of exposures should also be stated explicitly.

Lastly, attention is drawn to the need, for all companies, to provide ample and detailed information in the notes to the financial statements on the accounting policies adopted - including the choices implementing the general principles established by the IASs/IFRSs[10] – regarding financial instruments, particularly with reference to the valuation methods used for complex and/or illiquid instruments.[11]

C. Disclosures on testing for impairment

In the current economic environment, asset impairment testing is a fundamental process in the preparation of financial reports, considering, among other factors, the significant incidence of intangible assets, goodwill and equity interests on the balance sheet assets of some companies.

The disclosures on this testing are especially important for all persons interested in financial disclosures in order obtain an appropriate grasp of the entire asset valuation process (the basic assumptions, estimation methodology, parameters used, etc.) and assess the results of such valuations, and especially the reasons for the write-downs made.

The current environment of crisis, characterized by significant volatility of all the main market indicators and by deep uncertainty about economic expectations, make it difficult to develop forecasts that can be called reliable beyond the shadow of a doubt.

This situation also affects the economic and financial projections prepared by the directors in the preceding financial years, since the assumptions used may no longer be valid.

It is necessary that the directors pay special attention both in the valuation of assets to be submitted to a test for impairment conducted in accordance with IAS 36 *Impairment of assets*, and in the disclosures made in the notes to the financial statements concerning any impairment losses recognized during the period (IAS 36, paragraphs 126-133).

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[9] In particular, the FSF Report refers to the financial statement disclosures indicated in the document Leading-Practice Disclosures for Selected Exposures (April 2008), prepared by the so-called Senior Supervisory Group (see http://www.newyorkfed.org/newsevents/news/banking/2008/ssg_Leading_Practice_Disclosures.pdf).

[10] Consider, for example, in the case of an equity instrument classified in the portfolio as "available for sale", the need to indicate what is meant by "significant or prolonged declined in the fair value" of the investment (see IAS 39, paragraph 61).

[11] See the "Joint statement from CESR, CEBS and CEIOPS regarding the latest developments in accounting" (October 2008), available at www.cesr.eu, www.cebs.org and www.ceiops.eu.

In particular, the above-mentioned disclosures should consider the particular nature of the current context and report the differences found with respect to the previous-period valuations.

With specific reference to the disclosure required by IAS 36 for the impairment test of goodwill and intangible assets having an indefinite useful life (e.g. trademarks), attention is drawn to the fact that the directors must first of all specify the criterion used for determining the recoverable amount, i.e. value in use or fair value less costs to sell.

Where the recoverable amount is based on value in use, the following information must be disclosed in the notes to the financial statements: "*a description of each key assumption on which management has based its cash flow projections for the period covered by the most recent budgets/forecasts . . . ; a description of management's approach to determining the value(s) assigned to each key assumption . . . ; the period over which management has projected cash flows based on financial budgets/forecasts . . . and, when a period greater than five years is used, … an explanation of why that longer period is justified* . . ." (IAS 36, paragraph 134(d)(i-iii).

In addition, the following must be disclosed: "the discount rate(s) applied to the cash flow projections" and "the growth rate used to extrapolate cash flow projections beyond the period covered by the most recent budgets/forecasts, and the justification for using any growth rate that exceeds the long-term average growth rate" for the products, industries, country or countries or for the market) IAS 36, paragraph 134(d)(iv-v).

Where the recoverable amount is based on fair value less costs to sell, a description must be provided of the approach used and of every assumption on which the determination of fair value less costs to sell is based.

A further disclosure required by IAS 36, paragraph 134(f), is an analysis of the sensitivity of the result of the impairment test to changes in the key assumptions on which the result is based. The directors must pay attention in performing this analysis and providing all the information required by IAS 36. Such disclosure is all the more important given the current volatility of the financial markets and the uncertain economic outlook.

D. Uncertainties in the use of estimations

In conformity with the International Accounting Standards, in the notes to the financial statements the directors must disclose the judgments that it has made in the process of applying the company's accounting policies (for example, the classification of financial instruments in the different portfolios) and that have the most significant effect on the amounts recognized in the financial statements (IAS 1, paragraph 113).

Furthermore, adequate information must be disclosed in the notes to financial statements about the key assumptions concerning the future and other sources of estimation uncertainty that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the subsequent financial year (IAS 1, paragraph 116).

Such assumptions and uncertainties concern estimations that require the directors to make difficult - subjective or complex – evaluations. As the number of variables and assumptions taken into account increases, these evaluations become still more subjective and complex, and consequently the risk increases of a subsequent material adjustment to the value of the assets and liabilities stated in financial reports.

The disclosure required by paragraph 116 of IAS 1 must be made in a way that helps users of the financial statements understand the directors' evaluations concerning the future and other key sources of estimation uncertainty. The disclosure (nature of the assumptions or other sources of uncertainty, sensitivity of the carrying values to the basic methods, assumptions and estimations adopted, explanation of any adjustments with respect to the previous financial year, etc.) can vary depending on the nature of the assumptions and other circumstances.

This premised, and taking account of the current financial and economic crisis, it is advisable for directors to pay the utmost attention in making adequate and thorough disclosure of the reasons for the decisions made, assessments performed and the estimation criteria adopted in applying the International Accounting Standards.

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In the light of the above, and especially in the current market environment characterized by a heightening of uncertainty concerning the economic outlook, it should be stressed that boards of directors must be able to give adequate justification for every assessment and choice made in preparing financial reports and to support those assessments and choices with suitable documentation.

Lastly, directors must ensure consistency of the information provided in the financial statements and of the assumptions on which valuations are based with any forecasts and quantitative objectives concerning operations released to the public pursuant to Article 68 of Consob Regulation 11971/1999 ("Regulation on Issuers").[12] The need for consistency is heightened in the current crisis environment.

For the Bank of Italy	**For Consob**	**For Isvap**
The Governor	**The Chairman**	**The Chairman**

[12] Article 68 of the Regulation on Issuers states: "Issuers of financial instruments may disseminate forecasts and quantitative objectives for their operations and periodic accounting data provided such information is made available to the public in the manner provided for in Article 66. Issuers shall verify the consistency of the actual performance of operations with the forecasts and quantitative objectives disseminated and promptly inform the public of any significant deviation."

Example 1[13]

In the report on operations:

1. Reference is made to the parts of the financial statements that describe the group's business activities, together with the factors likely to affect its future development, performance and position; the financial position of the group, its cash flow, liquidity position and borrowing position; 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 exposure to credit risk and liquidity risk.

2. As highlighted on page W of the report, the group meets its day to day working capital needs through an overdraft facility that is due for renewal on date XXX. The current economic conditions create uncertainty particularly over (i) the level of demand for the groups products, (b) the exchange rate at which the raw materials used by the group are purchased, and (iii) the availability of bank financing in the near future.

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

Example 2[14]

In the notes to the financial statements:

1. Reference is made to the parts of the financial statements that describe the group's business activities, together with the factors likely to affect its future development, performance and position . . . .

2. As highlighted on page W of the financial statements, the current economic environment is especially difficult and the Group has incurred an operating losses for the year. Management is of the view that the outlook implies significant challenges in terms both of sales volumes and prices and of costs. Although management has taken measures to preserve cash and has succeeded in obtaining additional financing, these conditions create material uncertainty about future results and cash flows.

3. As explained on page Y of the financial statements, the directors are seeking to sell assets in order to procure additional working capital. The group is holding negotiations with a potential buyer but it is not certain that the sale will go through. On the basis of the negotiations so far, the directors have a reasonable expectation that everything will proceed in the best way, but if this proved not to be the case the group will need additional financing.

[13] The example refers to a non-financial company in the situation described in scenario 1.
[14] The example refers to a non-financial company in the situation described in scenario 2.

4. As clarified on page Z of the financial statements, the group has begun negotiations with the lending banks concerning an additional loan that could become necessary if the sale of assets did not go through, or if there were significant adverse changes in the volume of sales or in profitability. These negotiations are likely to last some time. Management is also looking for alternative sources in the event that the additional loan cannot be granted in the short term, but it has not yet received any binding commitment.

5. <u>According to the directors, owing to the set of circumstances described above, there is material uncertainty that may cast significant doubt on the ability of the group and of the company to continue to operate on the basis of the going concern assumption</u>. Nevertheless, after conducting the necessary checks and assessing the uncertainty, management has a reasonable expectation that the group and the company have adequate resources to continue in operational existence in the foreseeable future. For these reasons it continues to adopt the going concern assumption in preparing the financial statements.