

Going concern assumption for NHS trust accounts

Briefing note – March 2011

Purpose

This briefing note provides guidance to assist the directors of NHS trusts in understanding their responsibilities for assessing the going concern assumption when preparing the annual financial statements. It also provides directors with an understanding of the responsibilities of the trust's external auditors with respect to the going concern assumption when expressing their opinion on the financial statements.

Respective responsibilities of directors and auditors in relation to going concern

Going concern is a fundamental principle in the preparation of financial statements. Under the going concern assumption, a trust is viewed as continuing in operation for the foreseeable future with no necessity of liquidation or ceasing trading. Accordingly, the trust's assets and liabilities are recorded on the basis that assets will be realised and liabilities discharged in the normal course of business. A key consideration of going concern is that the trust has the cash resources to meet its obligations as they fall due in the foreseeable future.

International Financial Reporting Standards (IFRS) require the trust's directors to assess and satisfy themselves that it is appropriate to prepare financial statements on a going concern basis.

The Department of Health's (DH's) Manual for Accounts (MfA) adapts the requirements of IAS 1. Chapter 3 of the MfA sets out the following interpretation of going concern in the public sector context:

For non-trading entities, the anticipated continuation of the provision of a service in the future, as evidenced by inclusion of financial provision for that service in published documents, is normally sufficient evidence of going concern.

Notwithstanding this interpretation, many trusts have taken the view that the accounting standards require directors of trusts, particularly those which are in some financial difficulty, to assess the going concern position more formally than merely relying on the above presumption, with no further consideration.

It is not automatically presumed that trusts are a going concern. Where trusts are facing difficult economic conditions and/or are in financial difficulty, careful consideration will be required by directors when making their going concern assessment. It is expected that the assessment covers a period for at least 12 months from the date of the approval of the financial statements.

The auditor's responsibility is to consider the appropriateness of the use of the going concern assumption in preparing the financial statements and to consider if there are material uncertainties about the trust's ability to continue as a going concern that need to be disclosed in the financial statements.

Directors assessment of going concern

When conducting a formal assessment, directors should plan their assessment of going concern as early as practicable, including deciding on the processes, procedures, information, analyses and board papers that will be needed. These plans should also address the evidence to be obtained, including identifying any potential remedial actions that may need to be addressed, to support their conclusion prior to their approval of financial statements.

The specific factors that the directors should consider, that individually or collectively might cast **significant** doubt on the going concern assumption include:

- financial conditions, such as:
 - inability to meet the statutory annual financial targets
 - the need for central financial support to meet future obligations when they fall due
 - necessary DH loan facilities have not been agreed
 - DH loan facilities reaching maturity with little prospect of renewal
 - inability to repay DH loans when they fall due
 - existence of significant operating losses, historical and projected
 - anticipated or actual major loss of commissioner income
 - major cost improvement programme with high risk of non-achievement
 - major losses or cash flow problems which have arisen since the balance sheet date.
- operating conditions, such as:
 - loss of key management without replacement
 - loss of key staff without replacement and/or labour difficulties
 - significant failure to achieve Care Quality standards resulting in any restrictions on services provided
 - fundamental changes in the market or technology to which the trust is unable to adapt adequately.
- other conditions, such as:
 - serious non-compliance with regulatory or statutory requirements
 - pending legal or regulatory proceedings against the trust that may, if successful, result in claims that are unlikely to be satisfied

- changes in legislation or government policy expected to adversely affect the trust
- issues which involve a range of possible outcomes so wide that an unfavourable result could affect the appropriateness of the going concern basis.

Performing the going concern assessment

The existence of the above conditions will influence the degree to which the directors should request and consider evidence to support their assessment. Specific considerations might include:

- **forecasts and budgets** – directors should consider the trust’s budget, cash flow forecast or other equivalent analysis covering such period as they consider appropriate, but at least up to 12 months from the date of the approval of the financial statements. As a minimum, cash flow forecasts should provide monthly balances for the period to the end of the financial year, reflecting agreed commissioning contracts, with perhaps less detailed forecasts thereafter.

When the critical assumptions underlying the forecasts and budgets are challenged and subjected to sensitivity analysis, the refined forecasts and budgets have an increased likelihood of predicting the outcome. Key areas for consideration will include commissioning intentions and agreement of contract activity, and risk rating of the cost improvement programme in terms of timing and amounts. The capital programme cash flow forecasts and financing sources should also be included in the assessment.

In addition, directors should consider the extent of flexibility that might exist in the forecasts to delay the meeting of obligations, for example delaying elements of the capital programme.

- **access to funding** – the availability of DH loans may be dependent upon the trust’s compliance with specific terms and conditions (covenants). An analysis of long-term loans and conditions should be undertaken to ensure that all critical terms and conditions are identified so that the risks to continued compliance can be assessed.

The onus is on the directors to be satisfied that there is likely to be appropriate and committed financing arrangements in place. The cash resources available to the trust should be compared to the trust’s expected cash requirements from such facilities, as indicated by the cash flow forecasts, budgets or trading estimates.

- **medium and long-term plans** – directors should generally assess further periods beyond formal budgets and forecasts by way of medium or long-term plans that give an indication in general terms of how the directors expect the trust’s business to fare
- **health services and markets** – directors should obtain information about the major aspects of the economic environment within which the trust operates. They should assess whether there are any economic, political or other factors which may cause the health market to change. This should be done for each of the main service lines. Directors should assess whether their services are compatible with their projections in terms of their health market position and quality
- **timing of cash flows** – directors should assess whether their financial plans indicate an adequate matching of projected cash inflows with projected cash outflows. The projected outflows should include all liabilities and other commitments

- **contingent liabilities** – directors should consider the trust’s exposure to contingent liabilities. These should include sources of potential cash outflows during the review period relating to legal proceedings, environmental costs and service liability
- **financial and operational risk management** – there are many types of financial and operational risks facing a trust and directors should identify which risks are most significant to their trust. Consideration should also be given to counterparty risks that arise from concentration on key suppliers or commissioners who may themselves be facing financial difficulty. The directors should consider how such risks could affect the trust and how well they are managed in practice
- **sensitivity analysis and stress testing** – this should be prepared to enable an understanding to be

gained of the critical assumptions that underlie the budgets and forecasts. Sensitivity analysis involves assessing the extent to which cash flows vary with changes in assumptions. It should be used to ensure that there are no unexpected:

- shortfalls in working capital facilities against requirements
- breaches of covenants in working capital facilities.

Where sensitivity analysis indicates that there is a significant risk that the headroom between cash requirements and financing available will be insufficient, the trust 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 ‘red, amber, green’ (RAG) risk rating of cost improvement programme headings will assist in supporting sensitivity analysis.

Directors’ conclusion on the going concern assessment

Having considered relevant conditions and performed the assessment, the directors need to evaluate which one of three potential conclusions is appropriate to the specific circumstances of the trust. The directors may conclude one of the following:

- there are no **material** uncertainties that may cast **significant** doubt about the trust’s ability to continue as a going concern
- there are **material** uncertainties related to events or conditions that may cast **significant** doubt about the trust’s ability to continue as a going concern, but the going concern basis remains appropriate
- the use of the going concern basis is not appropriate i.e. the trust has no realistic alternative but to cease trading or go into liquidation.

Dependent on which conclusion is reached will determine the disclosures required and the consequences for the auditor’s report as shown in Table 1:

Conclusion	Resulting disclosure	Consequence for the auditor’s report
No material uncertainties related to events or conditions that may cast significant doubt about the ability of the trust to continue as a going concern have been identified by the directors.	Going concern is presumed in preparing financial statements. Disclosure will need to be made about liquidity risk, other uncertainties and key assumptions concerning going concern, as necessary. Disclosure of principal risks and uncertainties will be needed in the directors’ report.	Unmodified report provided the auditor concurs with the directors’ assessment and supporting disclosures. Very unlikely to have an adverse impact on value for money conclusion.
Material uncertainties related to events or conditions that may cast significant doubt about the ability of the trust to continue as a going concern have been identified by the directors, but the going concern basis remains appropriate.	Disclosures explaining the specific nature of the material uncertainties that may cast significant doubt and explaining why the going concern basis has still been adopted. Other disclosures will have to be made as described above.	Modified report including an emphasis of matter paragraph highlighting the existence of material uncertainties that may cast significant doubt provided the auditor concurs with the directors’ assessment and supporting disclosures. Possible qualification of the value for money conclusion in the report, dependent on scale of financial imbalance and risks to future recovery plan.
The going concern basis is not appropriate as the trust has no realistic alternative but to cease trading or go into liquidation.	Disclosures explaining the basis of the conclusion and the accounting policies applied in preparing the financial statements on other than a going concern basis and any uncertainties about the carrying amounts of assets and liabilities.	Unqualified opinion provided that the financial statements contain the necessary disclosures and the auditor considers the basis to be appropriate to the specific facts and circumstances. The auditor may include an emphasis of matter paragraph. If the decision and its implications are not adequately explained the auditor may determine it necessary to modify its opinion. Highly likely to result in a qualified conclusion on value for money in the report.

Disclosures in the financial statements

Disclosure requirements relating to going concern

Although there is a presumption under IFRS that the financial statements are prepared on a going concern basis, there is no specific requirement in the DH's Manual for Accounts for disclosure. However, it is worth noting that Monitor's Annual Reporting Manual requires foundation trusts to include a statement on whether or not the financial statements have been prepared on a going concern basis and the reasons for this decision, with supporting assumptions or qualifications as necessary. Where there is certainty over the going concern basis a typical disclosure statement reads:

After making enquiries, the directors have a reasonable expectation that the NHS foundation trust has adequate resources to continue in operational existence for the foreseeable future. For this reason, they continue to adopt the going concern basis in preparing the accounts.

Notwithstanding the absence of a specific requirement, we would encourage non-foundation trusts, as best practice, to make such a statement and where there is fundamental uncertainty over the going concern basis (for instance, continuing operational stability depends on finance or income that has not yet been approved), or where the going concern basis is not appropriate, the directors will need to disclose the relevant circumstances.

Liquidity risk disclosures

Liquidity risk is the risk that a trust will encounter difficulty in meeting its obligations associated with financial liabilities. IFRS 7 Financial Instruments: Disclosures requires a trust to make both qualitative and quantitative disclosures concerning liquidity risk, where it is a material financial risk. Where liquidity risk is material, IFRS 7 requires:

- disclosure of information that enables users to evaluate the nature and extent of the trust'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
- certain mandatory disclosures, such as a maturity analysis of financial liabilities.

The disclosures required by IFRS 7 are supplemented by disclosures required by other IFRS standards. For example, International Accounting Standards (IAS) 7 Statement of Cash Flows requires disclosure of undrawn borrowing or working capital facilities where relevant to users' understanding of the financial position and liquidity of the trust and IFRS 7 requires disclosure of defaults and breaches of loan terms and conditions.

Documentation of the assessment

The board of directors should request that the going concern assessment is documented in sufficient detail to explain the basis of management's conclusion with respect to going concern.

In addition, the directors should be invited to review and approve the documented assessment at the board meeting at which it is expected to approve the financial statements.

Specific considerations for the proposed dissolution of primary care trusts

The NHS Operating Framework sets out the Government's commitment to provide financial provision for the services that primary care trusts (PCTs) carry out in the 2011/12 financial year. Only where there is complete dissolution of a PCT without any continuation of operations is it likely the going concern basis would cease to be appropriate. The functions of PCTs are likely to continue to be provided by public bodies after their abolition, although the future of some PCT assets is unclear.

Auditor considerations of the directors' going concern assessment

International Standard of Auditing (ISA) 570: Going Concern, provides guidance to auditors on their responsibilities in relation to the going concern assessment and disclosures.



The guidance requires the auditors to consider whether there are material uncertainties to the going concern assumption by firstly evaluating the events and conditions relevant to the trust's circumstances.

The auditors will then evaluate the directors formally documented assessment by considering the process the directors followed to make their assessment, the assumptions on which the assessment is based and the plans for future action.

The auditors will consider whether the assessment has taken into account all relevant information of which they are aware as a result of their audit procedures. The auditors will then seek sufficient evidence in relation to some or all of the following matters:

- whether the period to which directors have paid particular attention in assessing going concern is reasonable in the trust's circumstances and in the light of the need to consider the ability of the trust to continue in operational existence for the foreseeable future
- the systems, or other means (formal or informal), for timely identification of warnings of future risks and uncertainties the trust might face
- budget and/or forecast information (cash flow information in particular) produced by the trust, and the quality of the systems (or other means, formal or informal) in place for producing this information and keeping it up to date
- whether the key assumptions underlying the budgets and/or forecasts appear appropriate in the circumstances, in particular the realism of cost improvement programme and income projections
- the sensitivity of budgets and/or forecasts to variable factors both within the control of the directors and outside their control

- any obligations, undertakings or guarantees arranged with other entities (in particular, lenders or suppliers) for the giving or receiving of support
- the existence, adequacy and terms of borrowing/working capital facilities and commissioner payment terms
- the plans of the directors for resolving any matters giving rise to the concern (if any) about the appropriateness of the going concern basis. In particular, the auditors will consider whether the plans are realistic, whether there is a reasonable expectation that the plans are likely to resolve any problems foreseen and whether the directors are likely to put the plans into practice effectively. The auditors will also take account independent and external views, if expressed, on the trust's financial position.

Where the directors' assessment indicates that there is significant reliance on the provision of working capital facilities or payment terms of commissioners to support the going concern assumption, the auditors may seek to obtain confirmation of the existence and terms of these arrangements and perform an assessment of the intentions of these parties.

Where representations of the directors are critical to the auditors obtaining sufficient evidence that the going concern assumption is appropriate, they will ask the directors to make written confirmations or representations to them.

The auditors will then conclude on which of the three possible conclusions referred to in Table 1 is most appropriate and determine the impact on their audit opinion, as appropriate.

Finally, the auditors will consider the appropriateness of the disclosures in the financial statements in respect of the requirements referred to above.

Further information

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