

LITTLEJOHN

# capital markets news

The newsletter for the  
AIM and PLUS markets

**ISSUE 1**

November 2009

## **Going concern**

Why honesty is crucial

## **Financial instruments**

The controversy rages on

## **AIM's wobble**

How equity houses stand to gain





## Welcome to Capital Markets News

Here's the first issue of our newsletter for AIM and PLUS clients, which we also hope will be of interest to others in either market – whether financial directors and chief executives of AIM and PLUS companies or AIM advisors such as NOMADs or lawyers.

As Head of Capital Markets, **Mark Ling** has led teams involved with numerous London Stock Exchange listings, management buy-ins, buy-outs, and related corporate finance activities. He has extensive experience in bringing international businesses to the capital markets.

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AIM was originally set up to be a forum for smaller, nimbler companies that had the potential to grow quickly. PLUS's revival, coupled with the recession, has forced many companies to reconsider where they need to be. PLUS is seen as a half-way house: a way of starting life as a public company, and may be more attractive in troubled times – with lower IPO and ongoing regulatory costs than AIM.

Next quarter, I believe the smaller equity markets are likely to remain very subdued. The movement we are starting to see at the top will take a long time to trickle down to AIM or PLUS. I predict both markets will be down on new issues well into 2010.

But I also think size matters less than aspiration. Companies really need to examine their motives for wanting to list and whether AIM or PLUS (or neither) fits with the long-term business plan. Understanding where the business is, is the theme of our main feature this issue – about going concern. Many development stage businesses are running out of cash, but ensuring that disclosures in financial statements are open and honest about going concern status is crucial for credibility.

We welcome your views on the newsletter.



## In Brief

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### Tax on corporate restructuring

The Treasury has changed the tax rules for corporate restructuring via debt buy-back, with initial legislation on 14 October and a further tightening on 9 November. It appears to have had banks in mind, as many had profited through discounted repurchases of their debt. But many other companies buying back debt at a discount will now have to recognise any profit made on the transaction, and any subsequent release of a debt in exchange for shares will also trigger a tax charge.

### Tax exemptions on foreign income

Many UK businesses now qualify for corporation tax exemption on dividends received from foreign companies, with effect from 1 July 2009. The rules are less generous for smaller companies, which can only claim exemption on dividends received from certain countries. Other corporation tax rules for foreign income remain unchanged. Overseas branch profits, for example, will continue to be taxed in the UK, with relief available for overseas taxes paid. As a result of the new exemption, the controlled foreign company (CFC) rules are expected to be reviewed shortly.

### Carry back extension reminder

Don't forget that up to £50,000 of trading losses suffered in accounting periods ending November 2008 to November 2010 can now be carried back against taxable profits of the previous three years. The rule has been extended from the earlier one-year limit.

Businesses that wish to obtain tax repayments should prepare accounts early to accelerate claims to relief.

### Auditor independence questioned

An Auditing Practices Board (APB) consultation paper, issued on 6 October, asks whether accountancy firms should continue to provide non-audit services to the listed companies they audit. The paper was in response to the Treasury Select Committee's report on the banking crisis, which called for a review of the matter. The report said: "We strongly believe that investor confidence, and trust in audit, would be enhanced by a prohibition on audit firms conducting non-audit work for the same company." This was also a key issue in the Enron debacle of 2002.

Some investors are sceptical that auditors in this situation can remain independent. The APB's Ethical Standards already imposes some restrictions but the consultation paper asks if a complete prohibition should be introduced. The paper turns a new spotlight onto KPMG's highly-publicised combined external-internal audit package offer to Rentokil. Clearly economically attractive to their client, it raises further questions about integrity and independence.

Comments to the APB are requested by 29 January 2010. You can access the consultation paper on the Financial Reporting Council website [www.frc.org.uk/apb/publications/pub2123](http://www.frc.org.uk/apb/publications/pub2123).



## As AIM wobbles, equity houses are ready

As some companies carefully review their AIM quotation, there is increased demand for take private deals. Odhran Dodd reports.

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Declining market values and shareholders' desire for cash have generated a unique opportunity for small and medium-sized companies to leave the market.

A tougher regulatory approach and greater emphasis on due diligence carried out on listing have led to an increase in listing costs – which amounted to 7% of funds raised in 2008, compared with 6.7% in 2007 and 6.2% in 2006.

### The figures have it

The first three months of 2009 saw only £3 million raised for five companies, while the first six months of the year saw only 13 listings, raising £225.9 million. The number of companies on the market – just 1,335 at time of going to press — is at its lowest now since 2005, with over 230 de-listings so far this year.

Of the companies still braving the public waters of AIM, 839 have values between £5 million and £25 million. Since 2008, 60% of AIM IPOs have been for between £5 million and £100 million.

These are values that sit in the sights of private equity houses looking to make acquisitions. Obviously some of the 839 will not fit the criteria, but we should expect offers for those that do. And private equity has the resources to make these acquisitions. So far this year, \$239.8 billion has been successfully raised globally by financial sponsors.

### Attractive proposition

Private equity houses looking to expand into a new sector can take a number of companies private in the same sector and operate a buy-and-build strategy to initialise and sustain some critical size, achieving both economies of scale and diversity. Those already active in a sector can acquire businesses as bolt-on acquisitions for their platform companies – at a fraction of what they would have cost even 18 months ago.

*“So far this year, \$239.8 billion has been successfully raised globally by financial sponsors”*



## Being open about going concern: why it matters

Company directors have been facing heightened anxiety about their ability to survive the economic downturn. If there are real doubts about whether the business can continue as a going concern, these must be disclosed clearly in the financial statements. Alastair Campbell explains why.

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Directors of companies have a legal duty to prepare financial statements on a going concern basis; that is on the assumption that the business will continue in operation for the foreseeable future, unless there are good grounds for assuming that it will cease. If there are grounds for believing the business will or could cease, the accounting policies adopted for the financial statements are likely to differ.

To take an example, if a business acquires plant for manufacturing purposes it will normally depreciate the plant over its useful life. If the life is estimated to be 10 years, at the end of year one the plant will be carried in going concern financial statements at 90% of its cost value. But if the going concern basis is not appropriate, the plant will need to be valued in the financial statements at its cash value in the second-hand market. This may be very substantially lower.

These differences and their presentation are not simply dry accounting theory. They may have a serious impact on the business' ability to continue.

### Who decides?

The decision lies squarely with the directors. Under the 2006 Companies Act directors are responsible for preparing financial statements which show a true and fair view of the state of affairs, and of the profit or loss for the accounting period. They also choose the accounting policies that should be adopted.

*“If there are grounds for believing the business will or could cease, the accounting policies adopted for the financial statements are likely to differ”*

Should nothing be stated to the contrary, readers are entitled to conclude that the financial statements have been prepared using the going concern basis. But directors should not simply assume the basis is appropriate. They should carefully consider the question for each set of financial statements and come to a firm conclusion either way.

### How to reach the conclusion

The Financial Reporting Council (FRC) issued guidance in October: *Going Concern and Liquidity Risk: Guidance for Directors of UK Companies\**. The guidance emphasises the importance of early consideration of going concern – preferably before the year end – and close liaison with the company's auditors.

It isn't possible to list a standard set of issues for all directors to consider. Each company or business will differ. But we can offer some guidelines as a starting point:

- make the process reasonably formal and support it with relevant evidence
- determine the appropriate period of the review based on the business cycle. The minimum period required by IAS1 is 12 months from the balance sheet date. But directors should avoid an unrealistically short review period, and ideally aim for a minimum period of about 12 months after the signing date
- review forecasts and budgets, and the assumptions underlying them, in the light of current business performance and the economic situation
- prepare cash flow forecasts for up to 18 months after the anticipated signing date of the financial statements
- review any borrowing requirements revealed by the forecasts and identify whether existing facilities will be adequate
- consider the potential financial impact of any contingent liabilities, such as disputes, to determine if there are adequate facilities to meet them.

\*See [www.frc.org.uk](http://www.frc.org.uk)

As well as these financial aspects, directors should look at wider trading issues, such as the ability of key suppliers to continue to provide at competitive prices, and the ability of key customers to continue to take the company's products.

Once the review is complete, it should be communicated to the whole board of directors for consideration. The review should be discussed and approved at the board meeting which considers the financial statements.

There will usually be three possible outcomes of the directors' review of whether the going concern basis is appropriate:

1. There are no matters revealed which cause any likely difficulty
2. The going concern basis is not appropriate
3. There are material uncertainties, but the directors believe they have strategies which mitigate their impact; the going concern basis is appropriate provided there is adequate disclosure of the issues in the financial statements.

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## Being open about going concern: why it matters (continued)

*“Auditors will need to consider whether the lack of confirmation represents a material uncertainty – or simply an increased caution from the bank”*

### **Disclosure of material uncertainties**

International Financial Reporting Standards have strict disclosure requirements dealing with material uncertainties. Generally the objective is to give readers sufficient and balanced information to enable them to form their own view about the relevant uncertainties. The disclosures will include, among other things, a statement of the facts and the assumptions made by the directors, and how the directors plan to resolve the difficulties.

Where there is enhanced liquidity risk – that is, of the company being unable to meet its obligations in relation to financial liabilities – accounting standards require further details of how liquidity risk arises and how it is managed, as well as numerical data and analysis of the maturity of financial liabilities.

### **The role of the auditors**

The role of the auditors is to give an opinion on the financial statements prepared by the directors. Part of their work will be to consider whether the accounting policies, including the assumption of going concern, are appropriate. They do this by considering the analysis and information on which the directors based their decision.

Auditors have to reach their own view on whether the going concern basis is appropriate. They may have to carry out additional work in certain areas if the going concern basis is felt to be inappropriate or when significant disclosures are required to deal with material uncertainties. For this reason, the earlier any going concern issues are identified and addressed, the more likely it will be that the production timetable for the financial statements can be achieved.

This additional work might include further analysis or obtaining further evidence from third parties, such as bankers, concerning the continued availability of borrowing facilities. In the current economic climate there have been instances where bankers have been unwilling to confirm that facilities will be available for the full period of the review. The FRC guidance emphasises that this situation does not necessarily jeopardise the company's application of the going concern basis. Auditors will need to consider whether the lack of confirmation represents a material uncertainty – or simply an increased caution from the bank. The greater the uncertainty, the more persuasive the evidence required by the auditors.

### **The current economic climate**

The credit crunch has increased directors' worries about whether their companies can survive the recession. Small wonder, then, that they are reluctant to make additional disclosures about going concern risks in their financial statements, in case that disclosure leads directly to pressure from creditors and financiers and a flight of customers which may bring about the very collapse they fear.

It is at least some comfort that all companies and all directors are in the same boat. Financial statements published in 2009 have included increased disclosures relating to going concern and liquidity issues – without apparent ill effects.

Full and frank disclosure can certainly demonstrate to the financial world that the directors of a company are aware of the issues and are taking steps to deal with them. In any event, where there are material uncertainties about the application of the going concern basis, it is worth taking considerable care to ensure the text in financial statements captures the true flavour of the position.



## Financial instruments: the controversy continues

Amid wildly opposed views, the International Accounting Standards Board (IASB) has gone back to the drawing board to rewrite IAS39. John Perry analyses progress so far.

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Accounting, some argue, was a key contributor to the financial crisis. The principles of IAS39 were blamed as excessively complex, and fair value accounting brought the volatilities of investment values onto the income statement. Tumbling markets led to significant losses and illiquidity of certain stocks, with pricing more akin to a 'fire-sale' than a reflection of true value or management's commercial intent.

In response, the IASB pushed through changes to IAS39 in October 2008 that allowed certain financial instruments to be reclassified as loans. As a result the significant write-downs were not booked on the income statement.

Some applauded the IASB for their actions. Others expressed concern that the approach went against the fundamentals of accounting by not reflecting the commercial reality but instead promoting a false, rose-tinted image indicating a greater level of stability than was actually there.

### The redefinition of fair value

As the furore continued, the IASB issued an exposure draft (ED) on fair value measurement in May this year. Its principal features were:

- a redefinition of fair value as "The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date" – clearly pointing to exit price but excluding prices set in distressed conditions
- illustrative examples
- enhanced disclosures.

Some argued the proposals didn't reach the heart of their concern, namely, whether fair value remains fit for purpose. But equally strong voices supported the IASB's view that the most robust means of assessing worth is the amount you could get in exchange.

*"Some applauded the IASB for their actions. Others expressed concern that the approach went against the fundamentals of accounting"*

After reviewing responses from the consultation period, the IASB will resume its deliberations on this matter in January.

### Rewriting IAS39

Following continued pressure and recommendations from the G-20, the IASB is now rewriting IAS39. First was the publication of an ED in July, followed by a revised standard – IFRS9 (Financial Instruments) – issued on 12 November. The aim was to have the standard ready for voluntary adoption in financial statements by this December, but it now looks unlikely to be endorsed by the EU in time for this to happen.

Key requirements include:

- reduction to only two measurement categories: amortised cost and fair value. Broadly speaking, if an instrument shows characteristics of a loan it will be valued at amortised cost; everything else will be fair value
- fair value applied to all equity instruments
- unquoted equity instruments measured at fair value (though in some cases cost may be an acceptable approximation of fair value).

A key difference between the ED and the standard is that the scope of IFRS9 currently only covers financial assets. In the light of feedback received, the IASB will reconsider the classification and measurement of financial liabilities and will finalise these requirements in IFRS9 in due course.

The second stage has been the publication, on 5 November, of an ED on impairment methodology. This will be followed by another, on hedge accounting, in the first quarter of 2010.

### What next?

Though the direction proposed suggests simplification and greater ease of understanding, it's clear the revised accounting standard will not satisfy everyone and the IASB cannot assume parties will be happy to compromise any time soon. As the accounting for financial instruments develops, it's important that accounting fundamentals are not compromised. The outcome must appropriately reflect the real world, rather than present an image of what people hope to see.

# LITTLEJOHN

Littlejohn is an independent, top 30 firm of chartered accountants and business advisors. A leader in providing audit, taxation and transaction support services to clients either already listed on the AIM or PLUS markets or planning to list, Littlejohn helps clients to overcome the challenges they face through a comprehensive commercial and technical understanding of their business and a high level of partner involvement. Clients range from small listed cash shells to multinational corporations operating in a number of countries.

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