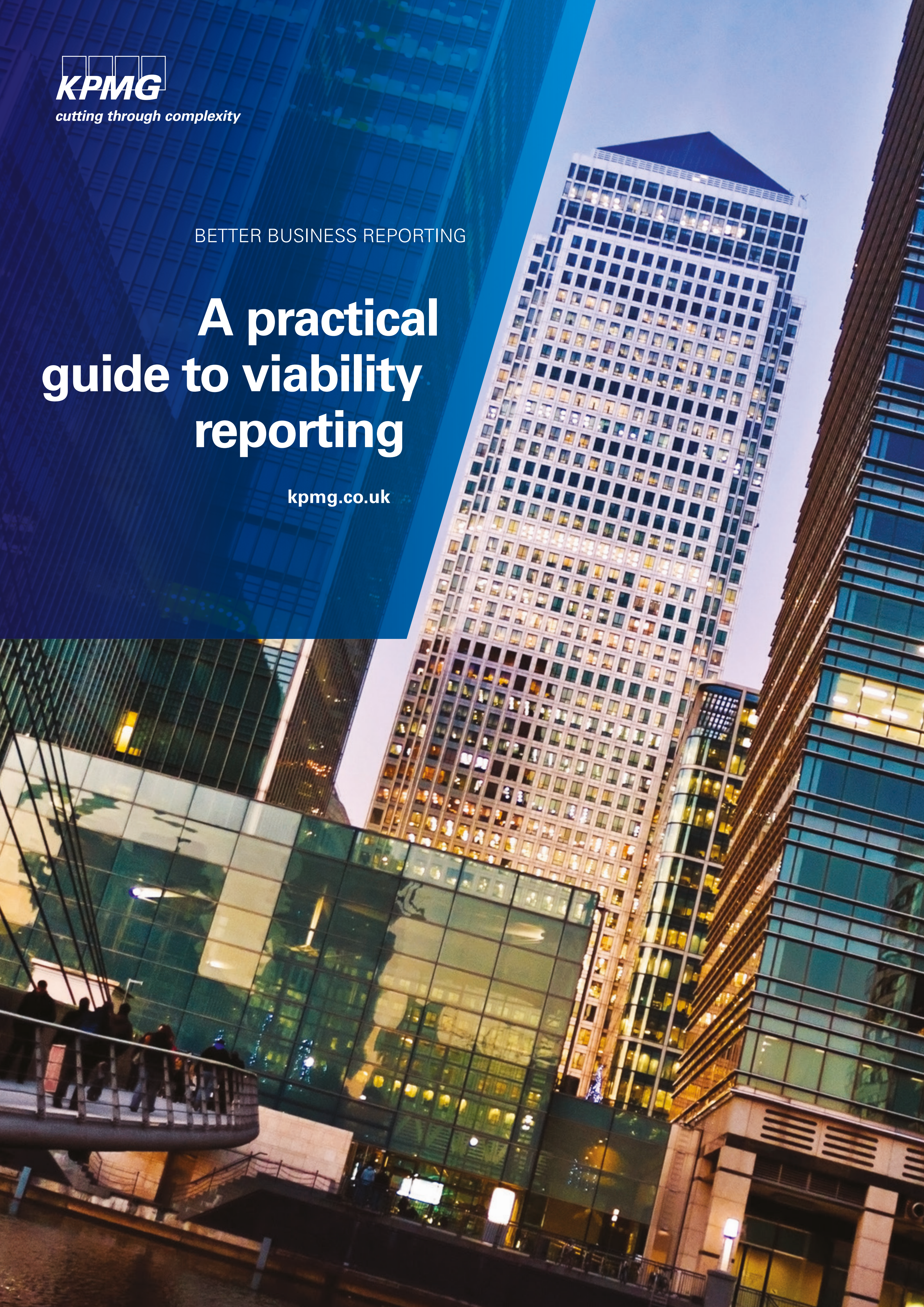

cutting through complexity

BETTER BUSINESS REPORTING

A practical guide to viability reporting

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Contents

Viability reporting: an overview

Changes to the Governance Code[1] introduced a directors' "longer-term viability statement" into annual reports for years beginning on or after 1 October 2014. Significantly, the Code also requires an explanation of the basis for this conclusion. The aim is to increase transparency over the risks and the board's view on them.

This viability reporting requirement – the statement and explanation – has its roots in the financial crisis, which saw the shock rescue of some banks and the shock failure of another, whose business model was reliant on wholesale credit markets, that, against all former expectation and experience, dried up – a so-called "black swan event".

The FRC's response is transparency: more information for shareholders about the risks and the board's views on them. The hopes are twofold: to focus boards on better governance, reducing the risk of failure; and to reduce surprises for shareholders.

To support this, the FRC has introduced two new provisions into the Code, effectively requiring:

- confirmations over (i) the robust risk assessment; and (ii) the longer-term viability statement; and
- supporting descriptions covering (i) the principal risks and their management and (ii) how prospects have been assessed.

The prospects assessment is not a statement of maintainable earnings or the company's ability to meet growth targets. Rather, it relates to the longer-term viability of the company – i.e. can it weather a severe but plausible combination of significant risks crystallising?

In some ways these new provisions are a restatement of existing requirements – the principal risks requirements of the strategic report, and Code provision C.1.2 on the business model. What is new is the emphasis on the negative, on the threats to survival, i.e., on what might be called the "critical failure factors". To meet this many companies may need to upgrade their reporting to move beyond coverage currently confined to the critical success factors.

At the same time the Turnbull guidance on internal control[2] is replaced by new FRC guidance[3] that additionally provides more guidance on longer-term viability, although the coverage of this is very brief. The FRC has put the two together because it sees longer-term viability as a part of regular risk management and not just an annual compliance exercise to support a couple of statements.

As they begin to think about these requirements, many companies' attention has been caught by just one of the four elements of this – the viability confirmation or statement – with some regarding it as a longer term version of the going concern statement.

We think that this is the wrong way to approach the requirements. The viability statement is about the company's ability to manage plausible "what-if" scenarios, not whether the company can avoid liquidation in a given time period (see page 2). Its more subjective nature makes the supporting narrative an essential accompaniment to the statement

Changes to the new Code

	RISKS	PROSPECTS
DESCRIPTION	**C.2.1 – Description of risk and mitigation** "The directors should describe • those [principal] risks and • how they are being managed or mitigated."	**C.2.2 – Explanation of prospects assessment** "Taking account of the company's current position and principal risks, the directors should explain in the annual report • how they have assessed the prospects of the company • over what period they have done so, and • why they consider that period to be appropriate."
CONFIRMATION	**C.2.1 – Confirmation of robust risk assessment** "The directors should confirm in the annual report that they have carried out a robust assessment of • the principal risks facing the company • including those that would threaten its business model, future performance, solvency or liquidity."	**C.2.2 – Statement of longer-term viability** "The directors should state whether they have *a reasonable expectation* that • the company will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, drawing attention to any qualifications or assumptions as necessary."

Where to start?

We think that the descriptions are the right place to start. Focusing first on a description of the risks, how they are managed and how their effects on prospects have been assessed, should help lead naturally to conclusions for the confirmation statements.

Put another way, the Code is asking companies to look at what they think their game-changing risks are and how they would manage them in a "perfect storm" for their business and financing structure – and ultimately whether they would survive it.

So to address survival, you need first to be clear as to what storm you could face. In this publication we look at the key factors involved in meeting the new Code:

- focusing on the right risks
- selecting an appropriate timeframe
- making the assessment
- explaining the assessment.

In practice: understanding the requirements

- The requirements mark a shift towards longer term thinking for business viability and risk management
- Whilst it's natural to focus on the directors' confirmation, getting the description of the assessment right is essential
- We think that some companies will conclude without needing qualifying assumptions, but many will not. This should not be thought unusual
- Good strategic reports will already go some way to supporting the basis for the directors' statement
- Boards will need to be focus on what is being assessed, not just the process of assessment.

Longer-term viability compared with going concern for accounting

Going concern accounting basis

Material uncertainties arise when risks have crystallised as active threats now.

The uncertainty is whether the company will avoid liquidation in the short term in the face of that active threat.

The test for using the going concern accounting basis is about avoiding liquidation in the short term – i.e. can the company foresee a realistic alternative to liquidation over at least the next twelve months?

The assessment is usually about cash flow predictions against facilities.

Longer-term viability

This reporting is more concerned with future scenario planning: what risks, which are latent now, could at some future point crystallise as threats to survival.

It is "what if"- if a risk crystallised as a threat, how would the company seek to manage it and how well? It's not a prediction of what will happen – it's not foreseeing the threat as an actual occurrence – but looking at the consequences for the company if it did.

Latent risks develop into threats over a longer timescale and so the period considered is necessarily longer.

The longer-term 'what-if' nature requires a more qualitative assessment.

1. The UK Corporate Governance Code, September 2014, FRC.

2. Internal control: revised guidance for directors on the Combined Code, October 2005, FRC.

3. Guidance on risk management, internal control and related financial and business reporting, September 2014, FRC.

Focusing on the right risks

So the first challenge – for some companies at least – is whether they have identified and focused on the relevant risks.

After all, in an ideal world the FRC would like companies to foresee the unexpected – those "black swan events". That is clearly impossible, but we suggest that boards could think about the following question as a straightforward, practical approach that is at the same time helpful to shareholders:

What factors, external or internal, that can't be taken for granted in the longer term, have the potential for a game-changing impact on the business?

This might help to sharpen the focus. Some strategic reports are criticised for including long lists of eclectic risks. This is arguably inappropriate under previous requirements, but the more so under the new Code with its emphasis on severe but plausible threats to the company's viability. So the first challenge may be to let go of surplus risks.

The next challenge is whether the company is addressing all the plausible risks of failure of the business model. To take a simple case, is the company vulnerable to a new class of "challenger" market entrant – for example, as we have seen in the food retail sector?

In answering this question it may be helpful to consider what a long-term shareholder would want his company's board to be alert to – to have on its radar. Non-executive directors, with their outside perspective, may have a particular contribution to make here.

In practice: approaching the challenge

- The business of business is risk taking. The disclosures are an opportunity to demonstrate that the board has its eyes open to the risks, and that it understands and is managing the balance of risk and reward to create shareholder value.
- Do the existing "principal risk and uncertainty" disclosures need reassessing?
- Boards will want to be confident that routine operational risks are being managed effectively in order that scenarios can focus on plausible, game-changing factors.
- Non-Executive Directors' external perspective can help the board step back to look beyond routine operational challenges to address the big strategic challenges.

Managing and mitigating risks

How the board manages and mitigates the risks is a matter of fact, disclosed as part of the required description. Of course, to the extent that rising to the FRC's challenge brings some new risks onto the radar, there are decisions to be made and implemented about how to manage those risks. This is one reason why the new Code provisions cannot be thought of as only a reporting matter that can be left until the annual report is being put together.

Basis for the assessment

"The statement should be based on a robust assessment of those risks that would threaten the business model, future performance, solvency or liquidity of the company, including its resilience to the threats to its viability posed by severe but plausible scenarios."

FRC guidance, appendix B, paragraph 4

Selecting the timeframe

A key consideration is the period to be covered. Yet it is not defined. After a number of attempts to provide a definition, the FRC settled for a choose-disclose-and-justify approach. However, its guidance does give a strong steer that the period ought to be a lot longer than a year.

We expect that period chosen will be influenced not only by sector – changes can happen faster in some sectors – but also by the extent to which any risks have crystallised as present threats for the particular company. A company facing crystallised threats is more likely to use a shorter period, in extremis even coinciding with its look-forward period for its assessment of the appropriateness of the going concern accounting basis.

A major factor will, of course, be the company's existing planning horizons. These are an obvious starting point. However, companies should recall that the FRC is aiming at improving longer-term planning; so should perhaps pause to ask whether their horizons could be longer.

Most companies will have multiple planning horizons, for example twenty-year strategic planning as well as five-year business plans and two years' of budgets/ forecasts. When using, most likely, the five year business plan as the starting point for their viability reporting, such a company might want to make clear that five years is not the limit of their planning considerations, explaining how they also look beyond that.

In practice: An appropriate timeframe

- We think it is likely that most companies will choose a timeframe of between three and five years.
- The less volatile – the less open to shocks – the longer it may be possible to look forward; and vice versa.
- The business's contracting cycles may influence the choice of timeframe for some, e.g. where there are a few, large, long contracts; but won't necessarily be relevant to all.
- Disclosures over assessment timeframes and the scenarios assessed are likely to attract particular investor focus. Longer-term prospects play a key part in most business valuations, so effectively explaining the rationale for the chosen timeframe will be key.

Period of the assessment

"Except in rare circumstances [the assessment period] should be significantly longer than 12 months from the approval of the financial statements. The length of the period should be determined taking into account a number of factors, including without limitation:

- the board's stewardship responsibilities;
- previous statements they have made, especially when raising capital;
- the natures of the business and its stage of development; and
- its investment and planning periods."

FRC guidance, appendix B, paragraph 3

Making the assessment

The FRC's guidance emphasises stress and reverse stress testing as a basis for conducting the assessment. Stress testing looks at a stressed scenario – the guidance talks about severe but plausible scenarios – and tests whether the company can withstand it. To continue with an earlier example, stress testing would consider how a challenger market entrant might affect the business over a given period. Reverse stress testing would look at what level of market disruption might cause the company to fail, and then ask whether that level is plausible.

Although the FRC's guidance says little else, we think that this is partly intentional, i.e. the FRC sees stress / reverse stress as the material point. To return to an earlier metaphor, it is asking companies to consider how they would fare in the perfect storm.

Confirmation thresholds

The confirmations require the board to decide, first, whether their assessment is "robust". This refers to the assessment of what the principal risks are (not the code provision C.2.2 assessment of the company's prospects and how it might fare if those risks crystallise). Although companies may need to revisit their list of risks, we think that most will have little difficulty in describing that assessment as robust, which the FRC describes as meaning "soundly based"[4].

More difficult is the threshold for having a "reasonable expectation" about longer-term viability. Where does this set the bar? There is no clear answer, as the FRC doesn't elaborate in this case.

In practice: plausible scenarios

- Boards will need to ask themselves whether they have sufficient evidence to support their risk assessment and viability confirmations
- Whilst it is likely that additional analysis will be necessary, existing business planning processes (forecasts and long term plans) may provide the starting point for supporting the statement
- Stress testing should be based on severe but plausible scenarios, focusing on the potentially game-changing factors that cannot be taken for granted in the longer term
- Are changes to existing stress and sensitivity testing required? Do they explicitly consider the potential impacts of principal risks in combined, severe but plausible scenarios
- It is unlikely that every downside risk will crystallise simultaneously. One might expect to see scenarios assessed against a broadly adverse – but not catastrophic – business environment
- Inter-dependencies between risks need to be considered – for example, a problematic business reorganisation may trigger the loss of key staff

Robust assessment

> **"[The robust] assessment should include sufficient qualitative and quantitative analysis, and be as thorough as is judged necessary to make a soundly based statement."**
>
> *FRC guidance, appendix B, paragraph 4*

[4] Paragraph 4, appendix B, FRC guidance

We think that a way forward might be the following three steps:

- Was the process, for assessing the prospects, a reasonable one in the circumstances of the significant, inherent uncertainty of a long look forward?
- If so, the resulting conclusion can be described as reasonable.
- If that conclusion is that the company would survive the "perfect storm", then there is a reasonable expectation of continuing in operation etc. If the conclusion is that it may not (or would not) survive, then the reasonable expectation is subject to the Code's "qualifications or assumptions" (i.e., that the perfect storm does not occur).

Qualifying assumptions

In respect of conclusions, we think that many if not most companies will conclude with qualifying assumptions. This should not be thought unusual. After all, the conclusion is just the result of scenario planning; it is not actually predicting the company's future. Moreover, the business of business is taking risks, and so it would be a surprise if scenario planning did *not* throw up instances where survival of the scenario is uncertain. This may be why companies objected strongly to the FRC's earlier proposal of a test of high confidence.

Mitigating actions

> **"The board's consideration of whether a risk or combination of risks could lead to an inability to continue in operation should take full account of the available and likely effectiveness of actions that they would consider undertaking to avoid or reduce the impact or occurrence of the underlying risks and that realistically would be open to them in the circumstances. In considering the likely effectiveness of such actions, the conclusions of the board's regular monitoring and review of risk and internal control systems should be taken into account."**
>
> *FRC guidance, appendix B, paragraph 7*

Reporting

We think that the reporting is most easily approached in three pieces: the descriptions, the period and the confirmations (see below for a simple, high level checklist).

On page 9 we illustrate the confirmations. On page 10 we quote examples of the description and the period; although the first pre-dates the new Code, we believe that it presents a good picture of how the directors have assessed the prospects etc (space does not permit it being quoted in full).

In our view, the confirmation statements are the least important component. The point of this new reporting is to give shareholders a better understanding of risk, mitigation and prospects, but binary confirmations (necessarily somewhat standardised) do not convey that at all. Moreover, getting the company-specific risk descriptions right will set the context for the confirmations.

We think too that it would be sensible to explain the company's approach to "reasonable expectation", given the lack of formal guidance on the threshold we include an illustration on page 9.

In considering where to report, the FRC highlights that statements that are included in the Strategic Report are covered by the so-called "safe harbour" provisions of the Companies Act.

In practice: explaining the assessment

- The board will need to confirm whether (i) the assessment was robust; and (ii) whether there is a reasonable expectation of continuing in operation.
- The narrative for the viability statement should connect with the rest of the annual report. The confirmation should follow from this.
- Disclosures relating to principal risks and how they are managed should map across the viability statement period.
- Descriptions of the viability assessment should focus on the outcomes of the board's process (what scenarios were assessed? why was the timeframe chosen?) rather than the process behind it. Providing transparency over the assumptions being made may give the board more confidence in making the viability statement itself.

Key features for reporting

1. Describe:

- the risks/critical failure factors (the things that could go into making the perfect storm);
- how they are being managed and mitigated;
- how the prospects are assessed. Not only the process, but what risks, scenarios, and stresses have been considered, together with an explanation of the approach to the "reasonable expectation".

2. Period:

- state, with reasons, the period over which the prospects of the company have been assessed.

3. Confirm:

- whether the risk assessment was robust;
- whether there is a reasonable expectation of continuing in operation etc.

Fitting it all together

It should be no surprise that viability reporting overlaps with other areas of the annual report. Explaining the viability statement effectively will require clear explanations of the business model and principal risks; after all, it is founded on and is a development of those. These should already be in place, and it would be sensible for all three to be placed together, so the reporting flows from the business model – to risks – to the viability reporting itself.

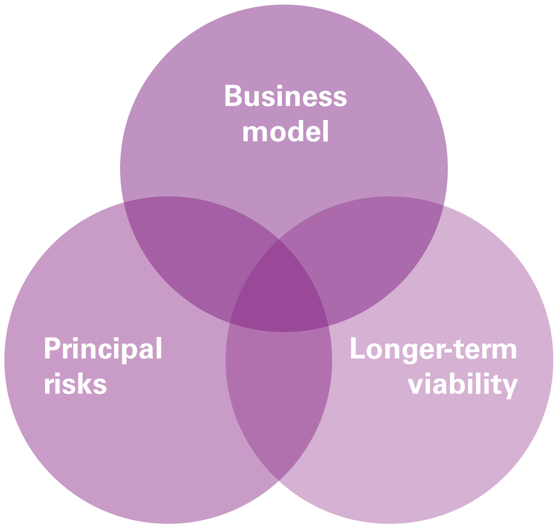
Clarity

In their reporting, companies should remember that, as always, the FRC has stressed the need to avoid boilerplate. It would also be sensible to look at the draft disclosures against the company's Listing Rules going concern statement. The two address different periods (and in different ways – see page 2). Is that evident from disclosures? If not, shareholders may confuse the going concern accounting statement period with that cited in the longer-term viability reporting.

Auditor's responsibilities

Companies should also be aware that the auditor is required to report on the new disclosures. The auditor must state, based on his knowledge from the financial statements audit, i.e. without doing any additional work, whether he has anything to add or draw attention to in relation to the company's disclosures, or state that he does not.

Relationship to other parts of the report



The investor perspective

Conversations with institutional investors suggest they would welcome insight into the judgments made by directors to understand how the business is managed through the cycle:

"The point is not to say 'this is the answer', but to provide investors with confidence that someone has stepped back and thought about it – and the approach to risk is the right one."

Clear, concise, specific

"As with all parts of the annual report and accounts, the board should provide clear and concise information that is tailored to the specific circumstances material to the company, and should avoid using standardised language which may be long on detail but short on insight."

FRC guidance, paragraph 46

Illustrative disclosures

Basis for the directors' reasonable expectations of the group's prospects

The directors' assessment of the group's prospects for the X year period is based on the stress-testing described below. The directors consider this to be a reasonable process and therefore allows them to form a reasonable expectation of the group's prospects in the circumstances of the inherent uncertainty of an X year period…

Confirmations

The directors confirm that their assessment of the principal risk facing the group was robust.

Based upon the robust assessment of the principal risks facing the group and their stress-testing based assessment of group's prospects, all of which are described above, the directors have a reasonable expectation that the group will be able to continue in operation and meet its liabilities as they fall due over the period to December 2020, subject to the assumption that…

Example disclosure extracts

Example description of the assessment process

"The corporate planning process is underpinned by scenarios that encompass a wide spectrum of potential outcomes for key global uncertainties driven by factors external to BHP Billiton. Designed to interpret technical, economic, political and global governance trends facing the resources industry, the scenarios offer a means by which to explore potential portfolio discontinuties and opportunities, as well as to test the robustness of decisions.

:

... Currently our Central Case considers expected levels of US economic recovery, progressive development of China and India, integration of developing economies into a multi-polar economic environment, as well as action on climate change centred on national policies with short-term prioritisation to adaptation and a long-term shift to mitigation.

The scenarios are designed to be divergent, but also plausible and internally consistent, spanning different potential future business environments. A description of the key charasteristics of each of our scenarios is summarised below: ...

:

- A future state enmeshed in stagnation and protectionism, regional conflicts abound, domestic resources are prioritised for consumption even if sub-economic, low investment in research and development, and climate change commitments are abandoned in favour of adaptation.

Alongside scenarios, associated signposts (trends) and triggers (events) allow early awareness for the potential advent of a scenario, offering a powerful decision-making tool. For example... if an accord on climate change were to be ratified during the 2015 United Nations Framework Convention on Climate Change Conference of the Parties, and then enacted globally."

BHP Billiton plc, 30 June 2014
(Selected extracts)

Example discussion of assessment timeframe

"In accordance with provision C.2.2. of the 2014 revision of the Code, the Directors have assessed the prospect of the Company over a longer period than the 12 months required by the 'Going Concern' provision. The Board conducted this review for a period of five years, which was selected for the following reasons:

i) The Group's strategic review covers a five-year period.

ii) For a major scheme five years is a reasonable approximation of the maximum time taken from obtaining planning permission to letting the property.

iii) Most leases contain a five-year rent review pattern and therefore five years allows for the forecasts to include the reversion arising from those reviews.

The five-year strategic review considers the Group's cash flows, dividend cover, REIT compliance and other key financial ratios over the period. These metrics are subject to sensitivity analysis which involves flexing a number of the main assumptions underlying the forecast both individually and in unison. Where appropriate, this analysis is carried out to evaluate the potential impact of the Group's principal risks actually occurring. The five-year review also makes certain assumptions about the normal level of capital recycling likely to occur and considers whether additional financing facilities will be required."

Derwent London plc, 31 December 2014
(Selected extracts)

Final thoughts

The FRC is seeking fewer business model shocks for shareholders through better risk management and transparency. Yet no board can guarantee no-surprises or foresee the unexpected. The FRC's guidance for companies is also brief, with open questions about what some of the requirements entail.

So we think that it will take a collaborative effort by all interested parties to make viability reporting a success – and that success is worth working for. We hope that regulators will understand the difficulties and not be critical of good faith efforts by companies.

More importantly, we trust that shareholders will appreciate the challenges that companies face and will provide feedback. If they feel that the board has not demonstrated why the shareholders should be confident that the board understands and is playing the long game, then companies need to know: what it is about their reporting that shareholders find lacking; where do they feel that management is missing the issues?

A better dialogue between companies and shareholders would be a good outcome in itself.

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