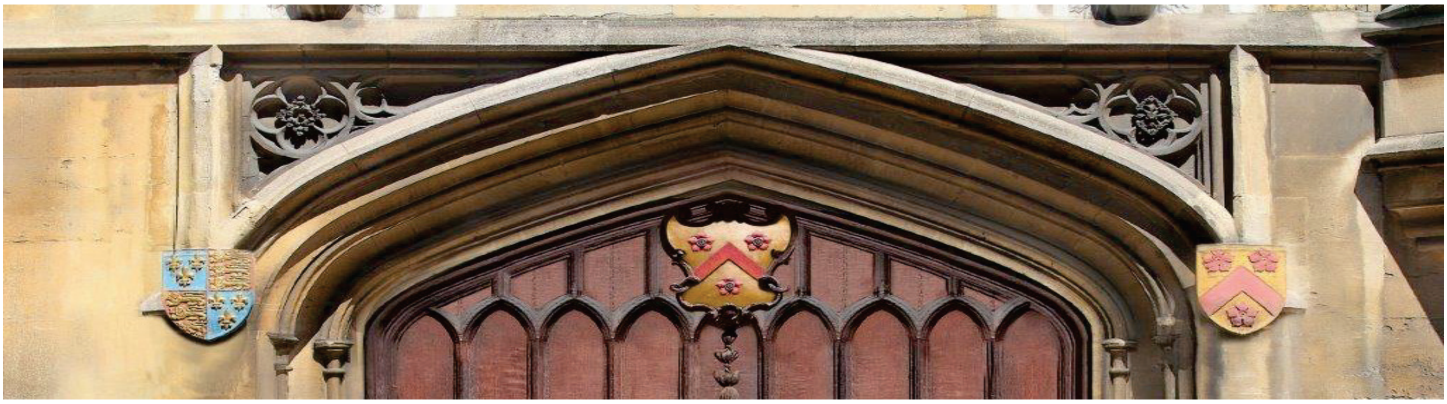
KPMG
cutting through complexity

Longer-term viability statements



The primary objectives of the 2014 amendments to the UK Corporate Governance Code (the Code) and Guidance on Risk Management, Internal Control and Related Financial and Business Reporting (the Guidance) – applicable to reporting periods beginning on or after 1 October 2014 – are to provide shareholders with an improved understanding of the Board's views on the management of risk and the longer-term viability of listed companies.

Risk management and longer-term viability are inexorably linked. A reasonable expectation as to longer-term viability requires a good understanding of the risks facing the organisation, how they are being managed and how the company would respond if they crystallised (as well as sound budgeting and forecasting processes).

There is some symmetry between the disclosures required in respect of risk management and longer-term viability. Both have an element of 'description' and 'confirmation'.

Describe:

- the principal risks and how they are mitigated by the company (Code Provision C.2.1).
- how, having taken account of the company's current position and principal risks, the directors have assessed the prospects of the company, what period the assessment covered, and why this period was appropriate (Code Provision C.2.2).

Confirm:

- that the directors have performed a robust assessment of the principal risks facing the company, including those that would threaten its business model, future performance, solvency or liquidity (Code Provision C.2.1).
- that the directors 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 (Code Provision C.2.2).

Key questions

Key questions that boards, audit committees and management might want to consider are:

Risk management

- What constitutes a "robust assessment of the principal risks" and has the board done enough to support the confirmation?
- Do the existing "principal risk and uncertainty'' disclosures (as already required by the Companies Act) need reassessing? Are all the principal risks included?
- Do the disclosures relating to the principal risks and how they are managed map across to the viability statement period?

Longer-term viability confirmation

- What period to choose - the longer the period the lower the degree of certainty?
- What are competitors and others doing?
- While it is likely that more work will be necessary, do the existing business planning processes (budgets and forecasts, etc.) provide a sound basis to support the statement?
- Are process changes required?
- Is the existing stress testing and sensitivity analysis fit for purpose? Does it explicitly consider the possible impacts of the principal risks? Is the company resilient to the threats posed by the principal risks (or a combination of such risks) in severe but plausible scenarios?
- What qualifications and assumptions are appropriate?

The principal risks

Focussing on the principal risks, how they are managed and how their effect on prospects has been assessed is the natural starting point for the confirmation as to longer-term viability.

Companies should already be disclosing their principal risks (as required by the Companies Act) and how such risks are mitigated. However, the amendments to the Code present an opportunity to reassess the appropriateness of such disclosures and in particular whether they present a realistic and meaningful assessment of the principal risks faced by the company.

The Code draws attention to those risks that threaten the business model, future performance, solvency or liquidity – i.e. the threats to survival (the 'critical failure factors') rather than the critical success factors that companies are generally good at reporting.

The description of the principal risks should provide shareholders with enough information to allow them to understand why these are important to the company and might include the likelihood of the risk and possible impacts on the company. Potential timing, significant changes in risks or their potential impact from prior periods should also be highlighted.

Assessing the company's prospects

The description of how, having taken account of the company's current position and principal risks, the directors have assessed the prospects of the company (and what period the assessment covered and why such a period was appropriate) is intended to provide meaningful information to shareholders.

Conversations with some major institutional investors have suggested that investors would welcome an insight into the judgements made by the directors so they can understand how the business is managed through the business cycle; and that the disclosures should provide insight. "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 that the approach to risk is the right one." Perfunctory or boiler-plate statements should be avoided.

Notwithstanding the period chosen for the longer-term viability statement, we believe that the disclosure as to how the company's prospects are assessed should be drawn as widely as possible.

Many companies have different planning horizons – a long-term strategic plan that might look ahead in excess of 20 years, mid-term forecasts such as a three year business plan and short-term budgets drawn over one or two years.

Where the longer-term viability statement is based on (say) mid-term forecasts, we believe that it would be good practice to disclose this fact in the context of the wider corporate planning framework. For companies with long business cycles (e.g. mining, oil and gas, etc.) this would be of particular relevance to shareholders.

BHP Billiton Plc's 2014 Annual Report includes some useful disclosures around the core principles governing their corporate planning, their corporate planning framework (Including both directional planning and delivery planning phases) and scenario planning. While such disclosures pre-date the 2014 Code amendments, they present a good analysis of how the directors have assessed the prospects of the company and form a basis on which to make the longer-term viability statement. (Strategic Report, Section 1.5.4).

Reasonable expectation

The required 'confirmation' relates to the longer-term viability of the company (i.e. whether the company can weather a severe but plausible combination of the significant risks crystallising). It is not a statement of maintainable earnings or whether the company will continue to meet growth targets. As such, it should be a statement that directors feel relatively comfortable about as they have a choice around the outlook period (and any necessary assumptions and qualifications).

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 those risks in severe but plausible scenarios. Such an assessment should include sufficient qualitative and quantitative analysis, and be as thorough as is judged necessary to make a soundly based statement. Stress and sensitivity analysis will often assist the directors in making their statement.

The board should consider the individual circumstances of the company in tailoring appropriate analysis. This should be undertaken with an appropriate level of prudence and may include analysis of reverse stress, starting from a presumption of failure and seeking to identify the circumstances in which this could occur.

The key question relates to what constitutes a 'reasonable expectation' as to longer-term viability? While this is for the directors judgement, we believe the answer rests in whether the process for assessing the prospects of the company was a reasonable one in the circumstances of the significant inherent uncertainty of a long look forward period. If the process is considered reasonable, then the resulting conclusion might also be described as reasonable. If the directors conclude that the company would survive the perfect but plausible storm, then there is a reasonable expectation of continuing in operation. If the conclusion is that it may not (or would not) survive, then the reasonable expectation would be subject to the Code's "qualifications or assumptions".

We think that it would be sensible to explain the company's approach to 'reasonable expectation'.

Period covered

The revised Guidance on Risk Management, Internal Control and Related Financial and Business Reporting states that, except in rare circumstances, the period used should be significantly longer than 12 months from the approval of the financial statements. The length of the period should be decided by the directors, taking the following into consideration: the board's stewardship responsibilities; previous statements made by the board and company; the nature of the business and its development stage; and the company's investment and planning periods.

In most circumstances, the period used will most likely align with the company's existing business plans (budgets and forecasts) - generally the period over which the company already produces reasonably reliable forecasts. The directors will need to be confident that routine operational risks are being effectively managed in order that scenario planning can focus primarily on plausible game-changing factors. Furthermore, as the FRC aim to improve longer-term planning, boards should pause to question whether their horizons could be longer.

Where a company has different planning horizons, we would anticipate that the directors would choose the longest period over which they consider their forecasts to be reasonably reliable in the context of assessing viability (rather than say profitability which would probably be much shorter). A 'reasonable expectation' (the confirmation standard required) does not mean certainty, but it does mean that the assessment can be justified.

It is likely that for most companies the period chosen will be in the three to five year timeframe. It is unlikely that directors would wish to confirm that they have a reasonable expectation that a company will continue in operation over (say) a 20+ year strategic planning horizon, even if they have no reason to believe the contrary is true. They may though want to make it clear that they have no reason to believe that the company will not be viable beyond the formal confirmation period.

Ability to continue in operation and meet liabilities as they fall due

Directors are encouraged to think broadly as to relevant matters which may threaten the company's future performance and so its ability to continue in operation and remain viable. Directors should consider risks to solvency (the company's ability to meet its financial liabilities in full), as well as liquidity (the ability to meet such liabilities as they fall due) – which may be a timing issue even if the entity appears to be solvent over time – and other threats to the company's viability.

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 availability 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.

Qualifications and assumptions

Any qualifications or assumptions to which the directors consider it necessary to draw attention in their statement should be specific to the company's circumstances, rather than so generic that they could apply to any predictions about the future. They should be relevant to an understanding of the directors' rationale for making the statement.

They should only include matters that are significant to the company's prospects and should not include matters that are highly unlikely either to arise or to have a significant impact on the company.

Good descriptions of the principal risks would usually form the basis for such qualifications and assumptions.

We think that many companies will draw attention to 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.

Placement

The FRC guidance anticipates that the principal risks, internal control and going concern and viability statements should be interlinked and notes that when considering where and how to report, boards should be mindful of the so-called "safe harbour" afforded by the Companies Act.

Directors are only liable to the company – for any loss suffered by the company as the result of any untrue or misleading statement in (or any omission from) the Strategic Report, the Directors' Remuneration Report or the Directors' Report - if they knew that the statements were untrue or misleading or if they knew that the omission was a dishonest concealment of a material fact.

Accordingly, provided directors do not issue a deliberately or recklessly untrue or misleading statement or dishonestly conceal a material fact by way of an omission, they will not be liable to compensate the company for any loss incurred by it in reliance on the report. In order to benefit from this protection, it is generally accepted that directors should ensure that information required in one of the three specified reports is included in those reports, either directly or via a specific cross-reference.

Checklist	
Disclose the principal risks/critical failure factors facing the company – including those that might comprise the perfect 'severe but plausible' storm	☐
Confirm that the directors have carried out a robust assessment of the principal risks	☐
Explain how the principal risks are managed and mitigated	☐
Explain how the prospects of the company are assessed – not only the process, but what risks, scenarios and stresses have been considered and why such an approach is considered reasonable	☐
State, with reasons, the period over which the board are affirming that they have a reasonable expectation that the company will continue in operation and why that period is appropriate	☐
Confirm that the directors 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	☐

Example statement

Assessing the prospects of the company

[Describe the corporate planning process or cross-refer to where it is described. Where relevant, provide information on the different planning horizons used by the company – short, medium and long-term.]

The corporate planning process is underpinned by scenarios that encompass a wide spectrum of potential outcomes. These scenarios are designed to explore the resilience of the Group to the potential impact of significant risks set out on page XX, or a combination of those risks. The scenarios can be summarised as:

- Solid economic growth – [Details – including any assumptions]
- Stagnation – [Details – including any assumptions]
- Depression – [Details – including any assumptions]

The scenarios are designed to be severe but plausible; and take full account of the availability and likely effectiveness of the mitigating actions that could be taken 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, as discussed on page XX, is taken into account.

The directors paid particular attention to [the risk that the Group's largest customer may not renew its contract with the Group in 2019 and the actions that the Group would take in those circumstances described on page XX above.

Alongside the scenarios, various signposts (trends) and triggers (events) alert the board and executive committee to the potential advent of a scenario. For example, we consider that this stress-testing based assessment of the company's prospects is reasonable in the circumstances of the inherent uncertainty involved.

The period over which we confirm longer-term viability

Within the context of the corporate planning framework discussed above, the directors have assessed the viability of the group over a variety of periods of up to 25 years. Whilst the directors have no reason to believe the Group will not be viable over a longer period, given the inherent uncertainty involved, the period over which the directors consider it possible to form a reasonable expectation as to the Group's longer-term viability, based on the stress testing and scenario planning discussed above, is the five year period to December 2020. This period – essentially the period used for our mid-term business plans – has been selected because it presents the board and therefore readers of the annual report with a reasonable degree of confidence whilst still providing an appropriate longer-term outlook.

Confirmation of longer-term viability

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

Based upon the robust assessment of the principal risks facing the company and their stress-testing based assessment of company's prospects, all of which are described above and on page [ ], the directors 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 to December 2020 subject to [insert any qualifications or assumptions].

Contact us

Timothy Copnell
Audit Committee Institute
T: +44 (0)20 7694 8082
E: tim.copnell@kpmg.co.uk

www.kpmg.co.uk