October 2015

Governance *in brief*
The longer term viability statement – a "how to" summary guide

Headlines

- The UK Corporate Governance Code requires a longer term viability statement for September 2015 year end reporters and onwards.
- Boards need to take a series of decisions in preparing for and drafting the statement, which will be dependent on the complexity of the business and its industry.
- Disclosures should be informative about the basis on which the board has formed its "reasonable expectation", and might include a brief description of the planning and forecasting process as well as, where necessary, drawing out any demand or market assumptions and risks and financing requirements.
- Auditors have significant additional reporting requirements on the Board's risk management disclosures and the forward looking viability statement, so early engagement with auditors will avoid last minute surprises.

Background

For companies with a September year end the time to produce their first longer term viability statement is rapidly approaching. This is a timely reminder and brings together what we are seeing as emerging practice.

The 2014 UK Corporate Governance Code is applicable for companies with periods commencing on or after 1 October 2014 – September 2015 and subsequent year ends. The requirement for the "longer term viability statement" comes from new Code provision C.2.2:

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. 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.

To assist directors the FRC also issued Guidance on Risk Management, Internal Control and Related Financial and Business Reporting.

So, where to start?

The overriding driver of this new statement is to provide shareholders with a clearer understanding of the way the board is managing the principal risks to their invested capital. That is why the FRC has also introduced the new Code provision asking the board to provide a statement that they have undertaken a robust assessment of the principal risks. Your longer term viability statement should focus on the processes by which the board manages and protects the business on a longer term basis. Preparing for this statement is likely to involve risk, finance and treasury teams as well as business leadership and of course the Board.

When drafting it is important to reflect on the wording in the Code provision. The directors have to explain "how they have assessed the prospects of the company" and it is the qualifications or assumptions relevant to these prospects which should be set out in the statement, where appropriate. This is in contrast to the "reasonable expectation" part of the statement which is a view on the company's ability "to continue in operation and meet its liabilities as they fall due over the period of their assessment". Both elements should be given proper consideration when developing the statement.

The board is going to take a number of decisions when preparing the statement:

1) the lookout period;
2) the principal risks to be factored into the analysis in terms of impact and timing;
3) the nature and extent of supporting analysis the board will want to see;
4) the qualifications and assumptions to disclose within the statement; and
5) the location of the statement within the annual report.

Decision 1 – The lookout period

The board statement on the appropriateness of the going concern basis of accounting remains unchanged and focuses on the period of twelve months from the date of signing. The viability statement provides the board with the freedom to choose "the period of their assessment" but the FRC's Guidance makes it clear that this period should be "significantly longer" than twelve months.

To date only a handful of companies have either presented a longer term viability statement early or have indicated in advance what their lookout period will be when they do present the statement. These companies have all used either three or five years so far.

The key point is that there is no expectation that boards should be inventing some new planning process or period to meet this Code provision (unless of course one is needed anyway).

Some companies prepare short, medium and long term "forward look" plans – there should be no problem with basing the viability statement on the medium term plan which would carry a greater confidence level than long term plans, if the period can be justified. It is also worth bearing in mind that inevitably investors and other observers will do an element of sectoral comparison.

Decision 2 – The principal risks to be factored into the forecasting

The Code provision asks the directors to explain "how they have assessed the prospects of the company" taking account of "the company's current position and principal risks". This requires the board and management to factor in the potential impact of the principal risks in the lookout period. This builds on the requirement on boards to make a statement that they have carried out a robust assessment of principal risks, to describe them and how they are mitigated.

Practically, for the viability statement, directors have to decide whether principal risks need to have impact quantified and possible timing determined in order to inform any stress testing they may require for their assessment (as described more fully in the FRC Guidance). This will be driven by the business model and the key drivers and measures of success used within the business. Is it cash, margin, earnings, profit or something else which is key and, based on that, which of the principal risks could have a significant impact on those drivers?

Decision 3 – The nature and extent of supporting analysis the board will want to see

If embraced by your company, there could be real benefits from this new Code provision in improved business and board process as well as further information in the annual report for investors. The FRC Guidance states that the assessment should include "sufficient qualitative and quantitative analysis, and be as thorough as is judged necessary to make a soundly based statement" and that "stress and sensitivity analysis will often assist the directors in making their statement".

The board should expect to see a series of board papers on this topic:

- an explanation of the new Code provision and the implications;
- a clear plan covering who, what, when and how – who is taking responsibility for the preparation of the statement and supporting analysis, what precisely the workplan is, when will the work take place and how will it be reviewed and appoved; and
- the final paper setting out the resulting analysis and the draft statement.

Broadly there are three different levels of analysis which the board could consider to support their statement on longer term viability:

Qualitative analysis	Low complexity and low data requirements but difficult to imagine how a sufficiently robust result could be achieved using only qualitative analysis. For example, considering the impact of combinations of risks is very hard to achieve on a qualitative basis alone or using solely reverse stress testing.
Scenario planning	Medium complexity and medium data requirements – this is likely to be the most popular level of analysis used outside of financial services in the early years. This should allow for consideration of a broader range of scenarios to be considered.
Modelling	High complexity and high data requirements – whilst common in the financial services sector to support regulatory requirements, this option is probably not available to others at the present time without significant investment. It would allow for the development of "at risk" measures for individual risks and combinations of risk.

The board should consider where on this spectrum it would like to land and perhaps consider this process as part of a journey where the ultimate aim is to have a more sophisticated modelling process in the future.

Decision 4 – The qualifications and assumptions to disclose within the statement

The board should draw attention to any qualifications or assumptions it believes necessary – this is the information which will help investors to understand the key underlying assumptions in the company's plans – these might relate to macro conditions, assumptions about commodity prices or exchange rates, or might relate to the evolution of the company's business model or might be assumptions about access to capital. The qualifications or assumptions need to be those material factors underpinning the viability statement that investors need to know.

The descriptions should be specific to the circumstances of the company and should focus on those qualifications and assumptions which are the most significant to the prospects of the company.

Decision 5 – The location of the statement

There are a number of options available in terms of location of this statement:

1) in the strategic report with or near the principal risks and risk management disclosures;
2) in the corporate governance statement; or
3) in the directors' report with or near the going concern statement.

This is up to the board but given what we said earlier about the longer term viability statement being underpinned by the assessment of principal risks, our suggestion is for it to be included with or near the principal risks and risk management disclosures in the strategic report.

This has two benefits: first, in demonstrating good integration with the risk management system and second, the directors benefit from protection of the safe harbour provision for forward looking statements given by the Companies Act 2006 (this would also apply to any statements made in the directors' report).

A summary of emerging practice

To date we have seen five FTSE 350 examples of a longer term viability statement. The following table summarises emerging practice:

Lookout period	• 3 or 5 years.
Reference to principal risks	• A cross-reference to the principal risks disclosure in the strategic report. • Note to say that the impact of the principal risks has been considered but no specific detail. • Small number of specific risks referred to in the statement.
Description of analysis performed	• Stress testing. • Scenario analysis. • Sensitivity analysis. • Not specified.
Reference to qualifications & assumptions	• All but one refer to some qualifications and assumptions.
Location in the annual report	• Strategic Report. • Directors' Report. • Corporate Governance Report.

Auditor reporting requirements to shareholders

The auditors have significant new responsibilities to report to shareholders in relation to aspects of the directors' disclosures on risk mangement and the viability statement.

First, auditors must review the statement for consistency with the other knowledge they have acquired during the audit, including the assessment of going concern, and whether the disclosures are in harmony with the overall requirement for the annual report to be fair, balanced and understandable.

Second, auditors have a significant new requirement to report in the audit report whether there is anything material to add or draw attention to in respect of the directors' confirmation that they have carried out a robust assessment of principal risks; the disclosures that describe those risks and how they are being managed or mitigated; the going concern statement and the longer term viability statement.

What will auditors wish to see?

Auditors are likely to ask for documentation of each of the steps above as they look to document their consideration of how your company has met those requirements. Ideally the auditors will be engaged in:

- understanding the overall process the board plans to adopt;
- challenging whether your assessment of the principal risks is robust;
- early discussions on the look-out period;
- early review of your company's assessment of the impact of principal risks on the company's plans;
- considering the integrity of the use of forecasts across the various judgements in the annual report and the financial statements e.g. going concern, viability statement, impairment reviews, tax forecasting; and
- reviewing drafts of the risk management and viability statement disclosures early in the audit process.

Management should be prepared to share board papers and other supporting documents covering the following:

- evidence of the robustness of the assessment of principal risks (process adopted, completeness and extent/depth of consideration);
- an evaluation of the likelihood and impact of principal risks on liquidity and solvency;
- reasoning for the choice of lookout period;
- confirmation that the viability statement forecasts are consistent with other forecasts used by the company – or clear explanations where this is not the case;
- details of any stress testing and scenario analysis performed and the results; and
- evidence of reporting to the board, including monitoring of risk management and internal controls.

For further information

Financial Reporting Council
The FRC's Guidance on Risk Management, Internal Control and Related Financial and Business Reporting can be found at https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Guidance-on-Risk-Management,-Internal-Control-and.pdf

Deloitte View

- The new requirement of the longer term viability statement is an opportunity to challenge existing business planning processes and ensure the integration and a fuller consideration of the impact of key risks.
- The longer term viability statement can be useful in drawing together many of the requirements of annual reporting – the business model and the principal risks in the front half of the annual report with the financing disclosures in the back half of the annual report.
- Businesses need to remember that it is about sufficiency of liquidity and solvency and it is not a statement about maintainable earnings – so the concept of materiality here is somewhat different to what might be material to users in relation to other elements of the annual report.

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Membership of the Deloitte Academy is principally for board directors of the FTSE 350.

For further details about the Deloitte Academy including membership enquiries, please email enquiries@deloitteacademy.co.uk.

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