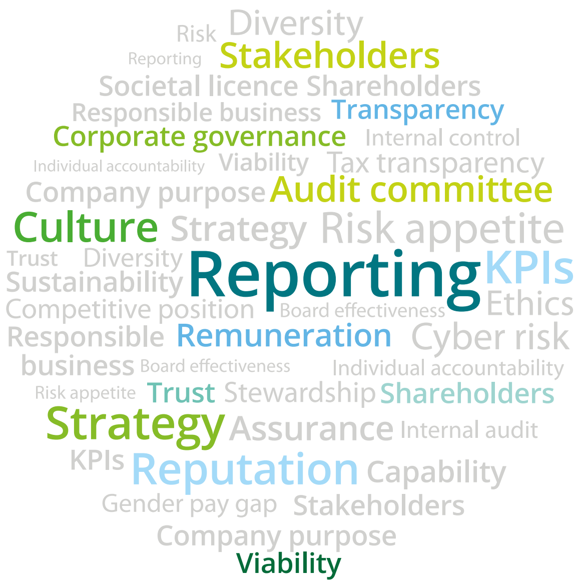


Governance *in brief*

The longer term viability statement – insights for year 2

Headlines

- The longer term viability statement, now in its second year, continues to be an area of focus for investors and regulators, with both the FRC and the Investment Association commenting on areas in which they wish to see improvement – as we have fielded a number of queries about Year 2 improvements we have summarised these in this Brief.

- Last year, we surveyed 17 of the largest September year end reporters, looking both at the longer term viability statement and the broader changes from the 2014 UK Corporate Governance Code regarding risk management. This year we have repeated the survey on the Year 2 September reporters and comment below where we think that is helpful to illustrate emerging practice.

Background

The 2014 UK Corporate Governance Code, supported by the FRC's Guidance on Risk Management, Internal Controls and Related Financial and Business Reporting, came into effect for periods commencing on or after 1 September 2014. We have now seen two sets of reports covering these requirements from September reporters, including the new longer term viability statement.

The Investment Association's Guidelines on Viability Statements

In November 2016, the Investment Association brought out a paper providing guidelines on viability statements, aimed at encouraging companies to provide disclosures that are more valuable to investors. These guidelines are based on a year's worth of experience and "will be reviewed in the light of best practice as it evolves."

The Investment Association's corporate governance research service, IVIS, will have regard to the guidelines when preparing its reports on companies.

The FRC's Developments in Corporate Governance and Stewardship 2016

The FRC has recently commented on its view of longer term viability statements so far. It considered that only 15% of the viability statements it reviewed were "comprehensive" – 13 out of 89. The key focus areas it proposes for companies to improve their longer term viability statements are:

- A clear rationale for choice of timeframe.
- What qualifications and assumptions were made.
- How the underlying analysis was performed.

The FRC provides three specific examples of companies it assessed as having comprehensive disclosure: Cobham, Fresnillo and National Grid.

The FRC's Developments in Corporate Governance and Stewardship Report also encourages companies to engage with investors to discuss what improvements they wish to see. The FRC's Financial Reporting Lab has indicated that it plans to launch a project on viability statements and related disclosures in 2017.

A clear rationale for choice of timeframe

The FRC identifies National Grid as an example of a company that indicates factors other than the business plan as to why a five-year time period was chosen.

> We believe that five years is the most appropriate timeframe over which the Board should assess the long-term viability of the Company. The following factors have been taken into account in making this decision:
>
> 1. We have reasonable clarity over a five-year period, allowing an appropriate assessment of our principal risks to be made;
> 2. The Board considered whether there are specific, foreseeable risk events relating to the principal risks that are likely to materialise within a five to ten year period, and which might be substantial enough to affect the Company's viability and therefore should be taken into account when setting the assessment period. No risks of this sort were identified; and
> 3. It matches our business planning cycle.

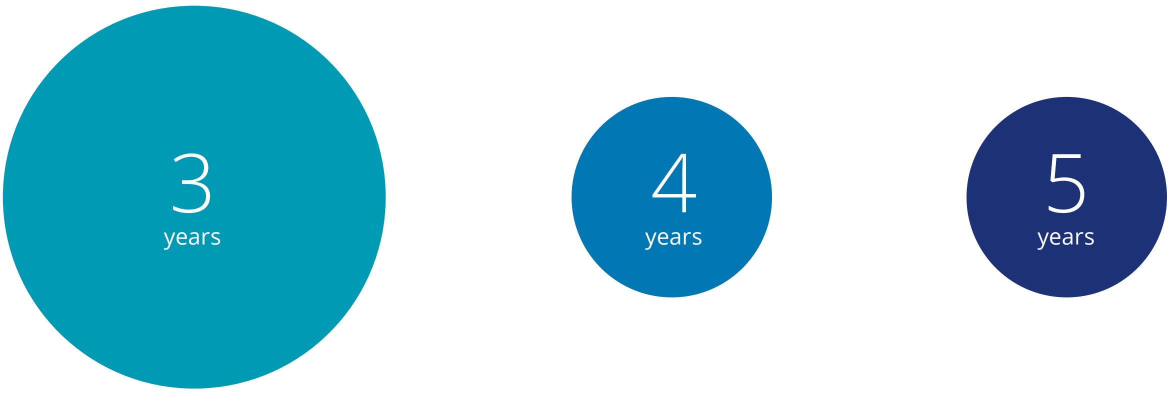
National Grid plc Annual Report and Accounts 2015/16, p30

The Investment Association's Guidelines on Viability Statements describes additional detail on what they would like to see on the period chosen for the viability statement: consideration of longer time horizons, stating clearly why the period was chosen and differentiating time horizons for prospects and viability.

Our survey found that most of the 17 September year end reporters still chose a three year lookout period for their longer term viability statement (11 of the 17, compared to 10 in 2015), with less than a handful of companies using four or five year lookout periods.

Four companies had changed their lookout periods. Of these, two had used a longer period in their 2015 annual report than they expected to use going forward – one due to a five year strategic review, the other due to financing arrangements. It was not a surprise to see either of these companies reducing their lookout periods by one year. One of the remaining two had increased the lookout period from three to four years without providing an explanation. The other reduced the lookout period from five to three years, citing alignment with a three year strategic plan and the nature of their industry.

Figure 1. What lookout period has been used by the companies surveyed?



11 companies | **3 companies** | **3 companies**

What qualifications and assumptions were made?

The FRC identifies Cobham as an example of a company that details assumptions made on current bank facilities in its viability statement:

> Based on the consolidated financial impact of the sensitivity analysis and associated mitigating internal controls and risk management actions that are either now in place, as described in detail for each principal risk on pages 35 to 37, or could be implemented, the Directors have been able to conclude that the Group will be able to operate within its existing bank covenants and maintain sufficient bank facilities to meet its funding needs over the three-year period. In coming to this conclusion, it has been assumed that a successful renewal including the £300m of mixed currency bank facilities is achieved in October 2018.

Cobham plc Annual Report and Accounts 2015, p34

The Investment Association's Guidelines on Viability Statements provides additional detail on what they would like to see on qualifications and assumptions, asking companies to differentiate between the two and ensure that qualifications and assumptions are specific to the company.

The Investment Association explains that "a company will continue to be viable on the assumption an event or condition occurs or exists. On the other hand a qualification means that the company will not be viable if something occurs or exists." It believes that there are likely to be more assumptions than qualifications.

The majority of companies in our sample - 13 out of 17 - disclosed assumptions or qualifications they had used in their viability assessment. This was a noticeable increase compared to the previous year. Only one company clearly separated and disclosed a qualification rather than an assumption, which related to the possibility of an unforeseen event outside the company's control.

> Based on the results of this analysis, the Directors have a reasonable expectation, predicated on the assumption that an unforeseen event outside of the Group's control (for example, an event of nature or terror) does not inhibit the Company's ability to manufacture for a sustained period, that the Group will be able to continue in operation and meet its liabilities as they fall due over the five-year period.

Victrex Plc Annual Report 2016, p24

In our assessment, just over half of the companies that disclosed assumptions or qualifications made them company specific. As expected, the most common assumption related to re-financing or availability of finance – if there are financing facilities falling due during the lookout period, most companies acknowledge and discuss this in their longer term viability statement. Other assumptions we have seen include sales volumes or pricing, availability or success of mitigating actions, contract renewals and cost management.

How the underlying analysis was performed

The FRC proposes three further "viability reporting suggestions" relating to the underlying analysis:

- Explain the background processes and analysis undertaken and reviewed by the board.
- Give details on the principal risks used specifically in the viability statement analysis.
- Provide information on modelling approach.

It identifies Fresnillo as an example of a company that lists the principal risks considered most important for assessing viability and that details the stress-testing scenarios used and what mitigations are in place:

> For the purpose of assessing the Group's viability, the Directors identified that of the principal risks detailed on page 37 the following are the most important to the assessment of the viability of the Group:
>
> A. 'Impact of global macroeconomic developments', specifically volatility in the prices of gold and silver over a period of time
> B. Access to land
> C. 'Potential actions by the government' which could include a delay in obtaining permits and/or new restrictive regulations
> D. Project delivery risks
> E. Environmental incidents
>
> It was determined that none of the individual risks, except for prices, would in isolation compromise the Group's viability. The Directors therefore went on to group principal risks into the following severe but plausible scenarios, in each case determining the risk proximity (how soon could the risk occur) and velocity (the speed with which the impact of a risk will be felt):
>
> **Scenario 1**
> **Impact of global macroeconomic developments**
>
> Over a period of a year, precious metal prices fall and then remain at a low level for the following four years of the viability period, varying between US$972-US$1,033/oz for gold and US$14.0-US$14.8/oz for silver. To create this impartial projection for the future low metal price environment, an average of the three lowest forecasts from each year of the assessment were used, based on consensus estimates published by Bloomberg at the end of December 2015. This low metal price environment was deemed to be the most significant risk and pervasive across the Company. *(Principal risk A)*

Fresnillo plc Annual Report 2015 p48

The extract above includes only one of the seven "hypothetical and extremely severe" scenarios examined by Fresnillo.

The Investment Association's Guidelines on Viability Statements asks companies to consider prospects and risks when assessing viability, including an assessment of the current state of affairs, the sustainability of dividends, distinguishing risks that impact performance from those that threaten operations, separating prospects from viability, stating clearly why the risks are important and how they are managed and controlled and prioritising risks.

The nature of the recommendations echoes the Investment Association's encouragement to non-executives to get under the skin of a company's forecasts to avoid resets of expectations so frequently seen on a change of management.

For stress testing, the Investment Association would also like companies to detail, like Fresnillo, the specific scenarios considered, the likely outcomes, specific mitigating or remedial actions and any reverse stress testing performed.

In our survey of September year end reporters, 15 out of 17 companies clearly described the nature of the analysis undertaken in their viability assessment. The vast majority performed stress testing and/or sensitivity analysis, with about half using a scenario planning approach, often in combination with stress testing or sensitivity analysis. Two companies also mentioned reverse stress testing, which is an approach welcomed by investors.

> As set out in the Audit and Risk Committee's report on page 77, the Directors reviewed and discussed the process undertaken by management, and also reviewed the results of reverse stress testing performed to provide an illustration of the reduction in revenue that would be required to break the Group's covenants or exhaust all available cash.
>
> The Directors' viability statement is contained in the Directors' Report on page 101.

The Sage Group plc Annual Report & Accounts 2016, p41

Most of the September viability statements reviewed had clear cross-referencing to the principal risks section or were located next to the principal risks section, however only nine companies named specific risks in their viability statement disclosure itself or explained how to identify these specific risks that had been considered.

A particularly clear example was in the Victrex annual report, where in the principal risks section each risk notes whether it has been considered in the viability statement or whether it has also been included in the sensitivity analysis performed.

Key

RISK CHANGE

No change **Risk increased** **Risk decreased**

VIABILITY STATEMENT LINKS

Risk considered Risk focused on in sensitivity analysis

Risk area and description	Mitigation	Change
Foreign currency risk		
The Group exports the majority of its product out of the UK, but has a significant Sterling cost base. Fluctuations in exchange rates between Sterling and US Dollar, and Euro and Yen could cause profit and balance sheet volatility.	The Group adopts a hedging policy to mitigate short-term currency risk. Currency movement can have either a positive or a negative impact on the Group. The Currency Policy is managed by a dedicated Currency Committee, including whether the impact of major events, like the UK's referendum on EU membership, requires any modification to that Policy.	
Business continuity and supply chain		
It is essential to ensure continuity of supply and service to our customers and that we can operate even if a significant event did occur. Failure to maintain a secure supply of high quality products to our customers by, for example, an unexpected upsurge in demand or delays in the implementation of major capital expenditure programmes, could lead to a capacity shortage or insufficient inventory and loss of earnings.	It is our policy to keep capacity ahead of demand by continual investment in our supply chain so that our customers can be confident that we can meet their requirements today and in the future. Our sales and operations planning process, together with our stocks of finished goods, which are held in a number of locations worldwide, is intended to enable us to maintain supplies to our customers during any short-term disruption. Additionally we work with our key suppliers to maintain appropriate stocks of key raw materials. We have business continuity plans in place that are regularly reviewed to ensure their continued effectiveness.	

Victrex Plc Annual Report 2016, p23

Investors also welcome an explanation of what could cause the risks to crystallise, the likely impact on the viability statement, and how this could be mitigated or managed. Only six companies in our sample provided this type of explanation. In addition, only six companies disclosed that they have considered principal risks in combination, not just individually.

Some final thoughts on our survey findings

Looking at the differences in reporting since last year, we found ourselves wondering: has the novelty worn off?

- More companies have moved towards a three year reporting period, including three that had a longer reporting period in 2015.
- While the overall quality of risk management and longer term viability statement disclosures may be the same or slightly better, some companies that were differentiated by the quality of their disclosures in the first year have not included the same level of detail.
- More companies disclosed qualifications or assumptions, but almost all of these new disclosures related to financing assumptions, rather than company or industry-specific matters.

In the end, the drive from regulators and investors is to obtain more and more valuable information through the longer term viability statement. This is all about good communication and companies that focus on long term relationships with investors and other stakeholders take the opportunities they are offered to share insights about their business.

Further information

Governance in focus: Audit committees and the 2017 reporting season can be found at **https://www2.deloitte.com/content/dam/Deloitte/uk/Documents/audit/deloitte-uk-audit-committees-and-the-2017-reporting-season.pdf**

FRC's Developments in Corporate Governance and Stewardship is available at: **https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Developments-in-Corporate-Governance-and-Stewa-(2).pdf**

FRC's Letter: Year End Advice to Preparers 2016 is available at: **https://www.frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/Letter-Year-End-Advice-to-Preparers-2016.pdf**

The Investment Association Guidelines on Viability Statements are available at: **https://www.ivis.co.uk/media/12490/Guidance-viability-statements-final2.pdf**

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

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