Viability assessments

Better business reporting

The process of performing the viability assessment has sparked a healthy debate in many boardrooms, but the full extent of the assessment is, in many cases, not being communicated.

The new viability reporting requirements have placed the onus on companies to explain how they are managing the long term risk of corporate failure. Whilst the initial focus was on the viability conclusion itself, descriptions of the assessment can provide new insight into the board's approach to the company's risks.

We looked at disclosures from 100 companies split between the FTSE100 and FTSE250. Whilst the assessment of viability has sparked a healthy board debate in many companies, we believe that the full extent of debate is in many cases not being communicated. As companies prepare for a second year of viability reporting, we encourage them to re-assess the scope of their first year disclosures: Could more insight be provided into the board's thinking on viability risks?

Based on our findings, the five key factors to consider for the next round of disclosures are:

1 | Selecting the right period
FTSE250 companies in particular need to consider whether a three year assessment genuinely reflects their specific circumstances and operational horizons: 91% had used a three year period – that seems high.

2 | Explaining how much visibility the board has
The choice of assessment period is best explained in the context of the commercial factors the company faces, but many explanations focused solely on the horizons set by the company's forecasting procedures, without providing insight into the commercial factors behind that horizon.

3 | Insight from the assessment
The most insightful stress testing disclosures describe the specific stresses that the board considered rather than simply outlining the process it had followed. Similarly, specific descriptions of the mitigating actions considered in stressed scenarios, are preferable to the general statement that mitigating actions have been assessed that many companies make. The most insightful disclosures addressed specific mitigating actions for particular risks, and also discuss how the board is placed to institute those actions if required.

4 | Qualifying assumptions
Where debt falls due for re-financing during the assessment period, the nature of stress testing means that this may need highlighting as a qualifying assumption. This should not be considered abnormal.

5 | A clear conclusion
The Code expects an unequivocal statement that the board's risk assessment was robust.

In addition, companies will also need to consider how Brexit may affect their assessment. The 'severe but plausible' scenarios on which the viability assessment is based may need to be revisited, with disclosure of the high level assumptions updated accordingly. The first step will be for companies to reassess their principal risk disclosures. Brexit may give rise to new specific risks, or it may change the balance of scale and likelihood of existing risks. These disclosures have an important role to play in demonstrating whether the board is on top of realistic downside risks, and should link to the related viability and governance discussions. In those specific cases where binary business-critical exposures exist, the statement may need to include qualifying assumptions. For example, in cases where a substantial part of the business depends on a particular aspect of the exit arrangements.

Assessment period

The choice of assessment period sends an important message over how much visibility the board really has. It should be based on the specific circumstances of the company, but over 90% of FTSE250 companies had selected the same three year assessment period. That may be the right period, but it should not be assumed.

Rather than ask companies to meet a specific assessment period, the FRC adopted a choose-disclose-justify approach, which should in principle allow companies to select the most appropriate period for their circumstances. The choice of period itself should therefore be insightful – how far ahead did boards feel able to look in respect of the statement?

All but one of the companies in our sample had selected a period of between three and five years; with one company looking ahead six years, though we are aware of a small number of companies outside our sample that have selected longer periods.

The majority of those looking beyond three years were from the FTSE 100. In fact, 91% of FTSE250 companies had selected a three year assessment period. We encourage FTSE250 companies to look at the specific circumstances of their sector and business when setting their assessment periods as more variation between companies might be expected.

Explaining the assessment period

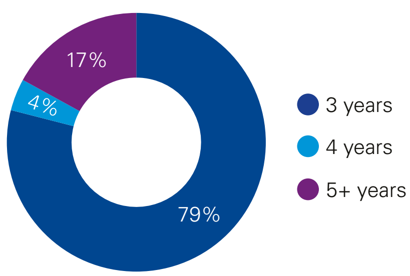
Most disclosures have provided new insight into the board's planning horizons, but only half have gone further by linking this to the commercial factors that drive those horizons.

Half of companies explained their choice of assessment period on the basis of the board's planning process and cycles. This is one of the factors identified by the FRC to be considered, but only one. It is understandable that companies choose to focus on this, as it provides objective support for the choice of period. Indeed, we think shareholders will welcome the added insight into the board's planning processes that many of these disclosures provide, offering a basis for further discussion with boards.

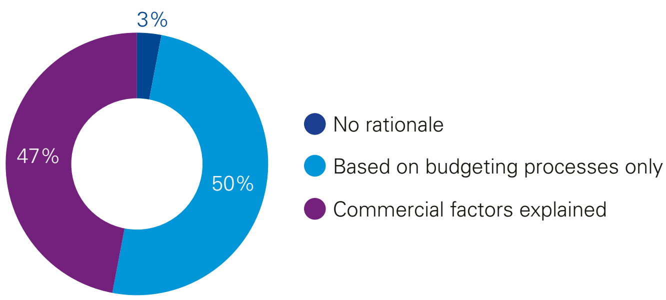
Many companies have selected a period that corresponds to their medium-term strategic planning period, so we expect that over time the choice of viability period may prompt deeper discussion over whether this is the right planning horizon. Just under half of companies go further than the process-based description by providing the commercial rationale, as was arguably envisaged by the FRC. The depth of these explanations vary significantly – whilst some provided limited insight, others offered added detail in areas such as customer or investment life-cycles that provided additional insight into the business model.

A number of explanations also addressed the longer-term planning processes that were also in place, making clear that the board's focus was not limited to the viability assessment period. Where this is done it is important to be clear on the commercial factors that caused the board to select a shorter period. Most, but not all statements that highlighted longer-term planning did this.

Viability assessment period



Basis for assessment period



> " Except in rare circumstances [the assessment period] should be significantly longer than 12 months… "
>
> *FRC guidance appendix B, paragraph 4*

> " The length of period should be determined taking into account a number of factors, including without limitation… the nature of the business and its stage of development; and its investment and planning periods. "
>
> *FRC guidance, appendix B, paragraph 3*

Stress testing

The most insightful disclosures describe the specific scenarios that boards have considered in their stress testing, but over half of companies limit the discussion to the process that was followed.

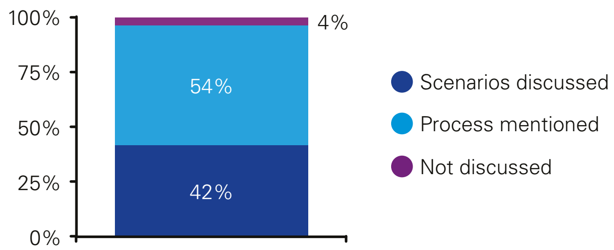
Stress, and in some cases, reverse-stress testing is cited in most viability statements. This is a key feature of the FRC's guidance on conducting the assessment. Just over half of companies limited their discussion to confirming either that some form of stress-testing process had been followed or, more helpfully, describing that process. Others went further by explaining what combinations of risks had been considered, or even the specific downside scenarios considered. One described the seven different scenarios that the board had considered as part of the assessment, providing real insight into how principal risks might crystalise, the effect they could have and how that could be managed.

Mitigating actions

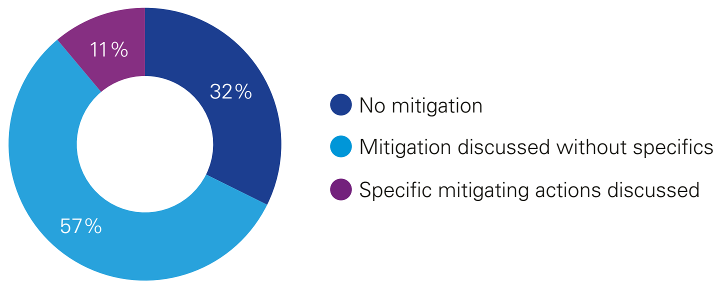
Few companies are taking the opportunity to explain how risk scenarios could be mitigated.

The practice of explaining how principal risks are mitigated by the company's policies, systems, and controls is well established, with principal risk disclosures describing how the company manages the likelihood of risks. Viability assessments take this a step further by asking for consideration of the actions open to the board to mitigate the impact of risks were they to crystalise. This should be a good opportunity to balance out the negative aspect of risk disclosures by explaining the positive steps that could be taken to reduce the impact on the business if the risk did, in fact, crystalise. In practice, few companies took this opportunity by describing the specific mitigating actions they might take. Nevertheless, the most insightful disclosures addressed specific mitigating actions for particular risks, and also discussing how the board is placed to institute those actions if required.

Stress Testing disclosures



Mitigating action disclosures



" 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… "

Governance Code C2.2

" The assessment 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. "

FRC guidance, appendix B, paragraph 7

Qualifying assumptions

Qualifying assumptions are relevant when the board's conclusion is based on specific assumptions that predicate their conclusion. Typically these will relate to the availability of finance.

Any assessment of a company's future prospects will depend on a set of assumptions, but the FRC's guidance asks for disclosure to be limited to those that are specific to the company. A good example of this type of disclosure relates to a company's ongoing access to finance. Six companies identified this as a qualifying assumption. A seventh identified the completion of a corporate transaction. We don't think this type of assumption should be seen as abnormal as it should be relevant to any company that is dependent on debt roll-over or refinancing in a stressed scenario.

A group assessment

Assessments should cover the group as a whole.

Ten companies in our survey had provided a conclusion over the viability of the company rather than the group. Whilst the Code is written from the perspective of a single corporate entity, FRC guidance specifies that all reporting should be from the perspective of the group as a whole, so readers will expect the viability assessment to be given on a group basis.

" 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… "

Governance Code C2.2

Matt Chapman
Better Business Reporting
T: +44 (0)20 7311 3236
E: matthew.chapman@kpmg.co.uk

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

www.kpmg.com/betterbusinessreporting

kpmg.com/uk

OLIVER for KPMG | August 2016 | CRT065108B