Going Concern and Long Term Viability – A Question of Confidence?

Wednesday, 4 March 2015

Martin Webster
What are we talking about?

• What a company says in its financial statements on:
  – Going concern
  – Risk (management, assessment, monitoring)
  – Prospects and long term viability.

• These are “comply or explain” requirements in the UK Corporate Governance Code applying to premium listed companies (and those who follow the Code as best practice) for reporting periods beginning on or after 1 October 2014.
Old position: going concern

- The directors should report in annual and half-yearly financial statements that the business is a going concern, with supporting assumptions or qualifications as necessary. UK Corporate Governance Code 2012, Provision C.1.3

- What was wrong with it?
  - “going concern” had an accounting meaning and, in common usage, suggested long term viability
  - audit reports were signed off with a going concern statement shortly before financial crisis struck
  - there was no explicit linkage with reporting on risk.
New position: going concern

In annual and half-yearly financial statements, the Directors are to:

- state whether they consider it appropriate to adopt the going concern basis of accounting
- identify material uncertainties in continuing as a going concern over at least 12 months from date of approval of financial statements.

UK Corporate Governance Code 2014, Provision C.1.1
Old position: risk

• The board should, at least annually, conduct a review of the effectiveness of the company’s risk management and internal control systems and should report to shareholders that they have done so. The review should cover all material controls, including financial, operational and compliance controls.

UK Corporate Governance Code 2012, Provision C.2.1

• What was wrong with it?
  – too little focus on risk in context of going concern
  – suggested boards need only look at risk once a year.
New position: risk assessment

In the annual report, the Directors are to:

– confirm they have carried out a robust assessment of principal risks, including those that threaten the:
  • business model
  • future performance
  • solvency, or
  • liquidity

– describe those risks and how managed or mitigated.

UK Corporate Governance Code 2014, Provision C.2.1
New position: risk management

• The board should:
  – monitor risk management/internal control systems
  – at least annually review their effectiveness
  – report on that review in the annual report.

• The monitoring and review should cover all material controls, including:
  – financial
  – operational
  – compliance controls.

  UK Corporate Governance Code 2014, Provision C.2.3
What else was missing?

• There was no forward looking view from directors of the business’s prospects

• Little information for shareholders on the Directors’ view of the company’s long term viability, and the assumptions on which that view is based

• “There is great value in opening the curtain a bit on the planning that is done and the discussions that have been had in the boardroom”.
  Stephen Haddrill, FRC
New position: long term viability

- Directors to explain in the annual report (taking account of company’s current position and principal risks):
  - how they have assessed the company’s prospects
  - over what period
  - why that period is appropriate.

- Directors should state:
  - whether they have a reasonable expectation the company will be able to continue in operation and meet its liabilities over that period
  - draw attention to any qualifications or assumptions.

UK Corporate Governance Code 2014, Provision C.2.2
Safe harbour – s.463 Companies Act 2006

• A director is only liable to the company (and no-one else)
  – if he knows (or is reckless) that there is an untrue or misleading statement in the Strategic Report, Directors’ Report or Directors’ Remuneration Report
  – or he knows an omission from those reports is a dishonest concealment of a material fact

• But these are voluntary statements, not required by CA 2006, so there is no certainty of this protection

• \( \frac{1}{2} \) year statements, US, prospectuses, FSMA liability…?
Long term viability, risk management and internal controls - 2014 Code

4 March 2015

Simon Lowe
Chairman, The Grant Thornton Governance Institute
Long term viability

Six key provisions

• C.1.1: Fair, balanced and understandable
• C.1.2: Business model
• C.1.3: Going concern
• C.2.1: Principal risks
• C.2.2: Risks and their impact on future viability
• C.2.3: Monitoring risk management and internal controls
Long term viability

Six key provisions

• C.1.1: Fair, balanced and understandable

• C.1.2: Business model

• C.1.3: Going concern

• C.2.1: Principal risks

• C.2.2: Risks and their impact on future viability

• C.2.3: Monitoring risk management and internal controls
Long term viability

So what is the fuss about?

"This statement is intended to express the director's view about the longer term viability of the company over an appropriate period of time selected by them"

(Appendix B, FRC Guidance on risk management internal control and related financial and business reporting)
It is all about the future, but....

Analysis of the strategic report – extract from the Grant Thornton FTSE 350 Corporate Governance Review 2014
Long term viability

So what is the fuss about?

"This statement is intended to express the director's view about the longer term viability of the company over an appropriate period of time selected by them" (Appendix B guidance on risk management, internal control and related financial and business reporting)

Stress and sensitivity analysis
Significance of variables to outcome
Simulation techniques
Investment and planning periods
Appropriate level of prudence
Resilience to stress
Sufficient quantitative and qualitative analysis
Long term viability

What do you need to think about?

• Risk management systems

• Forecasting and budgeting systems

• Finance strategy

• Business model

• Effectiveness of risk management and internal control systems

• Alignment with strategy
Challenges ahead

Assessment of the quality of disclosures of the effectiveness of internal controls and principal risks – extract from the Grant Thornton FTSE 350 Corporate Governance Review 2014
Viability statement

Some final thoughts for you to consider

• Length of period

• Definition of "significant"

• Documentation and disclosure
  - Specific rather than generic
  - Significant and likely
  - Cross referenced
A cycle of evolution

- **Business model and strategy**
  - Reassessment of business model. Code requirement C.1.2

- **Assess business prospects and sustainability**
  - Stress testing and sensitivity analysis against KPIs. Code requirement C.2.2

- **Identify key risks**
  - Identification, management and mitigation. Code requirement C.2.1

- **Systems, controls and processes**
  - Monitor effectiveness. Code requirement C.1

**Viability statement, documentation and disclosure**
The longer term viability statement – a question of confidence?

Survey results
We asked respondents to give us an indication of the approach they plan to take this year, and in three years’ time, to preparing to meet the requirements for the viability statement. Respondents had to indicate whether they anticipate being closer in their approach to the fictional Minimalist plc or Goldplate plc (see overleaf). Here are the common themes we identified from the survey:

• Companies are reluctant to look at a period of longer than three years, perhaps reflecting the increasing level of uncertainty as they look further to the future.
• Most companies anticipate taking a light touch approach to evaluation, particularly in the first year.
• Assessment is likely to consist of an extension of existing forecasting and planning rather than a completely new exercise.
• It is likely that the board will delegate responsibility to the audit committee, and that they in turn will task an executive with undertaking the assessment.
• Few companies anticipate consulting with investors on this issue in advance of publishing the annual report.
• Majority of companies are waiting to see what others will do.

What do you need to think about?
Making an assertion about longer term viability will require you to consider, draw on and explain a number of elements:

• Risk management systems
• Forecasting and budgeting systems
• Finance strategy
• Business model
• Effectiveness of risk management and internal control systems
• Alignment with strategy
• Quality and flexibility of existing forecasting model

Our recommendations
Don’t wait too long to start planning your approach. Schedule a board discussion to:

• agree length of period to be covered
• agree definition of “significant” in the context of the business
• agree the level of detail and insight you’re prepared to give – gold plate or basic
• allocate adequate resource
• determine responsibilities
• identify those significant risks against which the model will now be stress-tested.

Final thoughts
Whatever you say:

• avoid the generic
• be fair balanced and understandable
• recognise that reporting will evolve over time
• check back that your conclusion aligns with your going concern statement.
<table>
<thead>
<tr>
<th><strong>Minimlist plc</strong></th>
<th><strong>Goldplate plc</strong></th>
</tr>
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<tbody>
<tr>
<td><strong>Board sponsorship</strong></td>
<td>The Board delegated responsibility for overseeing the development of the viability statement to the Audit Committee. It tasked the CFO with developing the statement as part of their work on the Financial Statements. The Audit Committee reviewed the output as part of their annual review of the accounts.</td>
</tr>
<tr>
<td>1. Similar to Minimalist</td>
<td>For the first year, the Board appointed a working party to make recommendations on the preparation of the viability statement. It included the CFO, Company Secretary, Financial Controller, Head of Risk, Head of Business Planning, Treasury Manager, Head of Investor Relations. The Audit Committee was consulted throughout the process and approved key decisions.</td>
</tr>
<tr>
<td>2. Close to Minimalist</td>
<td></td>
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<tr>
<td>3. Somewhere in between</td>
<td></td>
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<tr>
<td>4. Close to Goldplate</td>
<td></td>
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<tr>
<td>5. Similar to Goldplate</td>
<td></td>
</tr>
<tr>
<td><strong>Time period</strong></td>
<td>The viability statement reflects the three year period covered by Minimalist’s strategic plan.</td>
</tr>
<tr>
<td>1. Now</td>
<td>The working party decided that a period of four years was consistent with Goldplate’s finance arrangements, contracts and product development lifecycle.</td>
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<tr>
<td>2. 2.7 years</td>
<td></td>
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<tr>
<td>3. Now 2.7</td>
<td></td>
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<tr>
<td><strong>Position in annual report</strong></td>
<td>Part of the discussion of strategy in the Strategic Report. Following the disclosure of significant risks and uncertainties in the Strategic Report.</td>
</tr>
<tr>
<td>1. Now</td>
<td>Goldplate reviewed the principal risk disclosures and highlighted in the viability statement how each had been considered and mitigated in preparing the viability statement.</td>
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<td>2. 3.2 years</td>
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<td>3. Now 3.2</td>
<td></td>
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<tr>
<td><strong>Discussion of risk</strong></td>
<td>The CFO reviewed the principal risks and recommended changes to provide further detail on how the board gained assurance that key risks were successfully mitigated.</td>
</tr>
<tr>
<td>1. Now</td>
<td>The working party conducted a discrete exercise which included:</td>
</tr>
<tr>
<td>2. 2.6 years</td>
<td>• forward planning exercise to identify scenarios and risks</td>
</tr>
<tr>
<td>3. Now 2.6</td>
<td>• evaluation of existing risk management/external controls, including the approach to quantifying risk impact and likelihood</td>
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<td><strong>Method of evaluation</strong></td>
<td>• modelling of 4 scenarios and stress testing for sensitivity to all key variables</td>
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<tr>
<td>1. Now</td>
<td>• identification of measures to improve forecasting performance management and risk identification</td>
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<tr>
<td>2. 3.2 years</td>
<td></td>
</tr>
<tr>
<td>3. Now 3.2</td>
<td></td>
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<tr>
<td><strong>Evidence</strong></td>
<td>The CFO maintained a working file documenting the work conducted and the basis for conclusions.</td>
</tr>
<tr>
<td>1. Now</td>
<td>Working files were maintained. Internal audit was engaged to review the approach taken. An external consultant was engaged to validate the models used.</td>
</tr>
<tr>
<td>2. 2.0 years</td>
<td></td>
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<tr>
<td>3. Now 2.0</td>
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<tr>
<td><strong>Investor engagement</strong></td>
<td>Following the publication of the annual report and accounts, the company invited questions from investors at the AGM.</td>
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<tr>
<td>1. Now 1.6</td>
<td>The working party met with several major investors and investment analysts when planning the viability statement methodology to discuss their expectations.</td>
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<td>2. Now 2.4</td>
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<tr>
<td>3. Now 2.0</td>
<td></td>
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