

REPORTING ON PRINCIPAL RISKS AND LONGER-TERM VIABILITY



The *UK Corporate Governance Code (September 2014)* introduced new requirements in respect of the reporting of the board's views on the principal risks and longer-term viability of the company. These new requirements apply to periods beginning on or after 1 October 2014.

BACKGROUND

In September 2014, the Financial Reporting Council (FRC) issued a revised version of its *UK Corporate Governance Code* (the 2014 Code). At the same time, it published *Guidance on Risk Management, Internal Control and Related Financial and Business Reporting*, which combined and updated the guidance previously included in:

- *Internal Control: Revised Guidance for Directors on the Combined Code (October 2005)*; and
- *Going Concern and Liquidity Risk: Guidance for Directors of UK Companies 2009*.

The 2014 Code introduced additional annual report disclosure requirements about:

- The directors' assessment of and approach to the principal risks faced by the company; and
- Their views on its viability over the longer term.

2014 Code Provision C.2.1

The directors should confirm in the annual report that they have carried out a robust assessment of the principal risks facing the company, including those that would threaten its business model, future performance, solvency or liquidity. The directors should describe those risks and explain how they are being managed or mitigated.

2014 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.

CONFIRM, EXPLAIN AND INTEGRATE

The 2014 Code requires directors to make two new statements in the company's annual report, namely that:

- They have carried out a robust assessment of the principal risks facing the company; and
- They have a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due over a specified period of assessment of their own choice.

These two new and explicit confirmations mean that directors will need to consider whether they have appropriate processes in place to enable them to justify the statements they make and may mean that some boards will have to take a more structured approach to their risk assessment process.

The descriptions and explanations that accompany the confirmations should make clear to shareholders that the directors have undertaken a thorough process in drawing their conclusions and highlight the key factors that have led to them. In many cases, this will require a richer description of the risks identified, their potential impact and whether and how the directors have sought to mitigate them than may previously have been presented in the annual report.

The interrelationships between the new requirements may also necessitate a more integrated approach to the disclosure of principal risks, internal control, going concern and longer-term viability. This could mean that companies applying the 2014 Code will need to reconsider the structure and location of these disclosures in their next annual report.

PRINCIPAL RISKS

As well as being a disclosure requirement in itself, an assessment and understanding of the principal risks facing the company is, along with the preparation and analysis of realistic budgets and forecasts, an essential part of the assessment of its longer-term viability.

The directors must pay particular attention to those risks that may, now or in the future, threaten the company's business model, future performance, solvency or liquidity. These are the most serious risks faced by the company; those that threaten its existence rather than those that threaten its ability to meet market expectations.

Assessment

The directors must confirm, in the annual report, that they have carried out a robust assessment of the principal risks facing the company. This assessment should include both a qualitative and quantitative analysis of the potential effect of the risks they have identified. It should:

- Identify the factors most critical to the achievement of the company's business plans and strategic goals and the risks that are associated with them.
- Consider other potential events and circumstances that may threaten the company's future performance and business model.
- Consider risks to liquidity and solvency as well as other threats to the company's longer-term viability.
- Assess the company's resilience to the risks identified in severe but plausible scenarios (eg stress and sensitivity analysis).

There is no one size fits all approach to this assessment. The directors should consider the individual circumstances of the business when tailoring their analysis to the company's position and performance, business model, strategy and principal risks. The analysis should be undertaken with an appropriate level of prudence. This may include reverse stress testing (ie starting from a presumption of failure and seeking to identify the circumstances in which this could occur).

Description

The description of the principal risks and uncertainties included in the annual report should be sufficiently specific for a shareholder to understand why they are important to the company. The report might include a description of:

- The nature of the risk and its origin;
- The likelihood of the risk;
- The circumstances under which the risk might be most relevant to the company; and
- Its possible effects, both financial and non-financial.

As the 2014 Code refers explicitly to threats to the company's business model, future performance, solvency or liquidity, the disclosures should also make clear whether, how and why the risks and uncertainties identified have a bearing on these matters.

Significant changes in principal risks, such as a change in the likelihood or possible impact or the inclusion of new risks, should also be highlighted and explained. A high-level but company-specific explanation of how the principal risks and uncertainties are being managed or mitigated should also be included.

In meeting these disclosure requirements, we would generally expect companies to disclose a relatively low number of risks but in sufficient detail for investors to properly understand their significance to the business.

LONGER-TERM VIABILITY

Explanation

The 2014 Code requires *an explanation of how the directors have assessed the prospects of the company* to be included in the annual report, not simply a statement that they have made that assessment. This is likely to involve some reference to the assessment process described above.

One of the most critical judgements in terms of the annual report disclosure is the period over which the longer-term viability assessment is made. The FRC expect that, except in rare circumstances, the period should be "significantly longer than 12 months" from the approval of the financial statements. The time period ultimately selected by a company will take into account a number of factors such as:

- The nature of the company's business and its stage of development;
- The industrial and general economic environments in which the company operates, including the predictability of operational and strategic risks inherent in them;
- The effectiveness of the company's day-to-day operational risk management;
- The availability and likely effectiveness of any realistic actions that could be undertaken to avoid or reduce the impact of the key strategic risks the company faces;
- The periods covered by existing formal budgets and forecasts;
- Its investment and planning periods; and
- Its projected financing needs.

The directors should choose the longest period over which they are confident of making their assessment. It should be consistent with the goal of assessing whether there is a reasonable expectation of longer-term viability, rather than that of assessing more detailed levels of performance or profitability.

Initial indications from September 2015 reporters and early adopters of the 2014 Code suggest that directors are basing their statements on their mid-term forecasts (generally three to five years). This is still a relatively short time frame and, to counter this, some companies have also indicated that they have no reason to believe that the company's viability will be threatened over a period longer than that covered by the positive confirmation of longer-term viability. This longer period could reflect the company's strategic planning horizon.

Confirmation

Finally, the directors must confirm in the annual report that they have a reasonable expectation that the company will be able to continue in operation over a specified period of assessment. This statement is in addition to, rather than in replacement of, the going concern basis of preparation statement.

The longer-term viability statement is not intended to be a statement of certainty; a "reasonable expectation" means exactly that. The FRC acknowledges that, the longer the period considered in the statement, the greater the degree of uncertainty that can be expected. The important point is that, irrespective of what the statement says, the judgements made at the time of approving it are both reasonable and supportable.

Given the timeframe used for the longer-term viability statement, compared to the going concern statement, it is expected that directors would need to make more sensitive assumptions. They may also have some specific concerns that would make them uncomfortable when making the longer-term viability statement. The existence of these assumptions and concerns need not necessarily restrict the directors' ability to make their confirmation over a longer timeframe, as long as they are adequately identified and explained.

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 effect on the company.

Examples of longer-term viability statements

We have reviewed the longer-term viability statements of 22 FTSE 350 September 2015 reporters and early adopters of the 2014 Code. Our key observations from this review are:

- The statements all covered a period of between three and five years. The majority (13) of the statements considered a period of three years, eight covered five years and one company chose a four-year period over which to make their confirmation.
- Forecasting, budgeting and/or strategic planning timelines were the most common justifications for the assessment periods adopted. Those that used other bases for the assessment period referred to business specific operational or financing issues.
- Five companies made broad comments concerning their viability beyond their chosen period of assessment.
- The level of detail provided on the assessment process and the assumptions made in it ranged from high level summary information to the description of more company-specific factors such as cash generation levels, loan redemption dates and interest cover.
- There was also a wide variety of approaches to the disclosure of sensitivity analysis and stress testing. Some reports stated that it had been undertaken but only a small number went into greater detail about the specific analysis conducted.

Four typical examples of longer-term viability statements are set out below. Additional examples are included in *Further Examples of Longer-term Viability Statements*.

Viability Statement

The Directors confirm that they have a reasonable expectation that the Group will continue in operation and meet its liabilities as they fall due for the next five years.

A period of five years has been chosen as this is the timeframe currently adopted by the Board as its strategic and financial planning horizon. This assessment of viability has been made with reference to the Group's current position and future prospects, its strategy, the market outlook and its principal risks and management thereof, as set out in the Strategic Report.

The strategy and risks to achieving the Group's five-year plan are reviewed by the Directors at their annual Strategy Day and again when the budget for the following year is considered. The five-year plan considers the Group's earnings growth potential, its cash flows, financing options and key financial ratios. The plan takes into account the economic outlook and principal risks in arriving at its key assumptions on expected turnover and cost pressures across the pub estate and beer business. It also takes account of estate development through innovation, investment and disposal opportunities.

Viability statement

The Directors have assessed the outlook of the Company over a longer period than the twelve months required by the 'Going Concern' statement in accordance with the 2014 UK Corporate Governance Code.

The assessment relied on the Medium Term Plan ('MTP'); Internal Capital Adequacy Assessment Process ('ICAAP') and evaluation of the Group's principal risks and uncertainties, including those that would threaten its business model, future performance or solvency.

The Group prepares annually, a five year MTP as part of its corporate planning process, which is a financial articulation of the Group's strategy. The Group continually improves the quality of its financial forecasting model, which is predicated on a detailed year one budget and higher-level forecasts for years two to five.

As a matter of good practice and as part of the ICAAP required by the Financial Conduct Authority ('FCA'), the firm performs a variety of stress tests including reverse stress tests. Three stress tests are performed; a market wide stress, a Group specific (idiosyncratic) stress and a combined stress taking into account both market wide and Group specific events. The stress tests are derived through discussions with senior management, after considering the principal risks and uncertainties faced by the Group.

The stress tests enable:

- the Group to model a variety of external and internal events that impact the MTP, identifying the potential impact of stress events on income, costs, cash flow and capital; and
- the Board to assess the effectiveness of any management actions that may be taken to mitigate the impact of the stress events.

The reverse stress tests allow the Board to assess scenarios and circumstances that would render its business model unviable, thereby identifying potential business vulnerabilities and ensuring the development of potential mitigating actions.

Following the assessment of the above, the Board concluded that the Viability Statement should cover a period of three years. Whilst the Directors have no reason to believe that the Group will not be viable over a longer period from its assessment of the MTP, this period has been chosen because a three year time horizon has a much greater degree of certainty and provides an appropriate longer term outlook.

Taking account of the Group's current position and principal risks and the Board's assessment of the Company's prospects, the Directors have a reasonable expectation that the Group will be able to continue in operation and meet its liabilities as they fall due over a period of at least three years.

Brewin Dolphin Holdings PLC
Annual Report and Accounts 2015

Viability statement

In accordance with provision C.2.2 of the 2014 revision of the Code, the Board has assessed the prospects of the Company over a longer period than the twelve months that has in practice been the focus of the 'Going Concern' provision.

The Board conducted the review for a five-year period, corresponding with the period covered by its current forecasts. These forecasts are updated quarterly and reflect the Group's established strategy of investing in London's West End, its existing investment commitments, available financial resources and long-term financing arrangements. They consider profits, cash flows, funding requirements and other key financial ratios over the period, as well as the headroom in the financial covenants contained in our various loan agreements. Important assumptions underlying the forecasts include:

Assumption: Crystallisation of the portfolio reversionary potential over the period. *Comment:* We have a long record of crystallising the independently assessed ERV of our portfolio over a three-to-five year period. 63% of the total portfolio reversion comes from shops, restaurants, cafés and pubs, the demand for which, in our locations, is not cyclical and has demonstrated sustained growth over many years. See details on reversion on page 40.

Assumption: The Group had undrawn committed loan facilities at 30 September 2015 totalling £150.3 million, which comfortably exceeds the Group's commitments over the assessment period. This assumes an ability to re-finance revolving credit facilities totalling £150.0 million and £125.0 million which mature in 2018 and 2020 respectively. *Comment:* The Group maintains a prudent approach to gearing, with debt facilities which are largely fixed and long-term in nature. At 30 September, our loan-to-value ratio was 22.5%. The facilities which mature during the period of assessment represent 18.8% and 15.7%, respectively, of our total committed debt facilities. The Board has reasonable confidence that we shall be able to refinance these facilities and intends to do so in advance of their contractual maturities. See the finance review on page 56.

The principal risks are set out on pages 61 to 63 and the most relevant potential impact of these risks on viability was considered to be:

- A substantial and sustained decrease in visitor numbers to the West End and our villages which could result in reduced occupier demand, rental income and/or capital values, higher vacancy and declining profitability
- Regulatory changes which reduce profitability and capital values
- Changing economic conditions which reduce capital values, and put pressure on loan covenants

The Board overlaid the potential impact of the principal risks which could affect solvency or liquidity in "severe but plausible" scenarios onto the five-year forecasts and concluded that the business would remain viable. As part of this, they performed sensitivity analyses that flexed inputs to the forecasts including reduced income, profitability and capital values, both individually and in unison, to reflect these severe but plausible scenarios.

Based on the results of the procedures outlined above, the Directors have a reasonable expectation that the Group will be able to continue in operation and meet its liabilities as they fall due over the five-year period of their assessment.

Shaftesbury PLC
Annual Report 2015

Viability statement

The Directors confirm that they have a reasonable expectation that the Group will continue to operate and meet its liabilities, as they fall due, for the next three years to September 2018. The Directors' assessment has been made with reference to the resilience of the Group and its strong financial position, the Group's current strategy, the Board's risk appetite and the Group's principal risks and how these are managed, as described in the Strategic Report.

The Group has a broad spread of customers and suppliers across different geographic areas and independent market sectors, often secured with longer term agreements. The Group is supported by a robust Balance Sheet and strong operational cash flows.

The assessment period of three years has been chosen as it is consistent with the Board's triennial review of the Group's strategy at which the prospects of each business are discussed; assumptions are made regarding entering into new markets and geographies, about future growth rates of the existing businesses and about the acceptable performance of existing businesses. A robust financial model of the Group is built on a business by business basis and the metrics for the Group's KPIs are reviewed for the assessment period. These metrics are also subject to sensitivity analysis which includes flexing a number of the main assumptions, namely, future revenue growth, gross margins, operating costs and working capital management. The results of flexing these assumptions, both individually and in aggregate, are used to determine whether additional bank facilities will be required during this period.

This review and analysis also considers the principal risks facing the Group, as described on pages 35 to 37 and the potential impacts these risks would have on the Group's business model, future performance, solvency or liquidity over the assessment period. The Board considers that the diverse nature of the Sectors and geographies in which the Group operates acts significantly to mitigate the impact any of these risks might have on the Group.

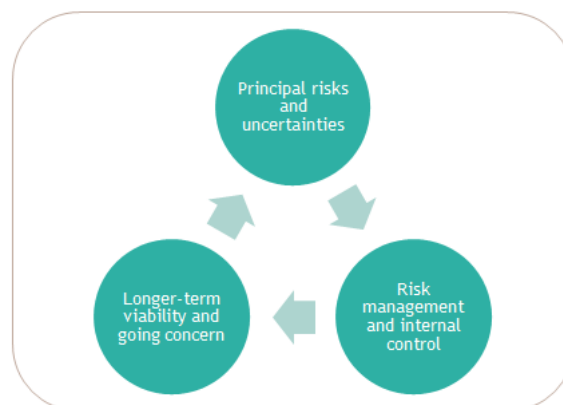
Diploma PLC
Annual Report and Accounts 2015

GROUPS

For groups of companies, all reporting should be from the perspective of the group as a whole. An explanation should be given of how the board assesses and manages the risks faced in relation to investments in material joint ventures and associates. Where the board does not have access to, and oversight of, detailed information concerning those entities' business planning, risk management and internal controls, this fact should also be disclosed.

LOCATION OF DISCLOSURES

As noted above, the interrelationships between the new requirements may also necessitate a more integrated approach to the disclosure of principal risks, internal control, going concern and longer-term viability. This means that companies might wish to reconsider the structure of their disclosures in respect of these areas in order to better highlight the linkages between them and also to reduce the levels of unnecessary duplication and cross-referencing in the annual report.



For example, directors should consider whether and how to link their reporting on the review of the company's risk management and internal control systems to the information on the principal risks and uncertainties it faces. They should also consider whether the longer-term viability statement should be presented with the description of principal risks and uncertainties which might affect the company's longer-term viability and/or with the disclosures relating to the use of the going concern basis of accounting in the financial statements. Each of these disclosures are, to a greater or lesser extent, linked to the others.

It is convention rather than mandatory requirement that has led to the common practice of including the disclosures required under the UK Corporate Governance Code in a separate governance section of the annual report. Other than the need for the annual report to be fair, balanced and understandable, there are only two factors relevant to the location of these disclosures:

- Firstly, the Companies Act requires the description of the principal risks and uncertainties faced by the business to be included in the strategic report. This is usually achieved through its direct inclusion in the strategic report but it may also be achieved through a clear and specific cross-reference to another part of the annual report.
- Secondly, directors may wish to take advantage of the "safe harbour" protection afforded to them under the Companies Act. The safe harbour provision means that directors are liable to compensate only the company if the company suffers any loss 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. In addition, the directors are only liable to the company 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.

The majority of companies in our sample chose to include their longer-term viability statement in their strategic report, either just before or just after the discussions of principal risks and uncertainties. There were also individual instances of it being presented in the directors' report and the corporate governance statement.

EFFECTIVE DATE AND SCOPE

Companies that are required to apply the UK Corporate Governance Code, and those that choose voluntarily to do so, must apply the 2014 Code for accounting periods beginning on or after 1 October 2014.

Whilst companies that choose voluntarily to apply the 2014 Code may, as with any other provision of the UK Corporate Governance Code, adopt the requirement to make a longer-term viability statement on a comply or explain basis, companies with a Premium Listing on the London Stock Exchange are in different position. As has previously been the case for the statement on the appropriateness of adopting the going concern basis of accounting (Code provision C.1.3), the Listing Rules also now require the directors to include a longer-term viability statement in their annual report. In other words, the option not to include a longer-term viability statement in the annual accounts and, instead, to explain non-compliance with provision C.2.2 of the 2014 Code has been removed by the Listing Rules for companies with a Premium Listing.

ROLE OF THE AUDITOR

The role of the auditor has also been expanded in relation to these new requirements. As has previously been the case for the going concern statement, Listing Rule 9.8.10R(1) now requires that the auditor reviews the longer-term viability statement. The list of UK Corporate Governance Code provisions requiring auditor review set out in Listing Rule 9.8.10R(2) has also been up-dated to include:

- The directors' confirmation that they have conducted a robust assessment of the principal risks facing the company; and
- The description of the principal risks and an explanation of how they are being managed or mitigated.

CONCLUSION

The drafting of an appropriately detailed and sufficiently balanced and supportable longer-term viability statement that takes into account commercial sensitivities and the directors' own personal exposure may take a considerable amount of time. Similarly, drafting principal risk disclosures that meet the enhanced expectations of the 2014 Code may be time consuming. It is essential, therefore, that directors leave adequate time in their accounts preparation timetable to properly consider these disclosures.

FURTHER INFORMATION

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