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Lab project report:

# Risk and viability reporting

November 2017



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### What is the Lab?

The Financial Reporting Lab was set up by the Financial Reporting Council (“FRC”) to improve the effectiveness of corporate reporting in the UK. The Lab provides a safe environment for listed companies and investors to explore innovative reporting solutions that better meet their needs.

Lab reports do not form new reporting requirements. Instead, they summarise observations on practices that investors find useful to their analysis and encourage companies to consider adopting the practices if appropriate in the context of their own reporting. It is the responsibility of each reporting company to ensure compliance with relevant reporting requirements.

Published reports and further information on the Lab can be found on the FRC’s website: [www.frc.org.uk/Lab](http://www.frc.org.uk/Lab)

### Do you have suggestions to share?

The Lab encourages readers of this report to provide comments on its content and presentation. As far as possible, comments will be taken into account in shaping future projects. To provide comments, please send us an email at:

[FinancialReportingLab@frc.org.uk](mailto:FinancialReportingLab@frc.org.uk)

# Quick read

## Principal risk reporting

### Quick questions for companies on their principal risk disclosures

- Does the description of principal risks identify how they are specific to the company?
- Is it clear how the company categorises and prioritises principal risks?
- Are movements in principal risks, including movements into and out of the principal classification, explained?
- Is it clear how the principal risks link to other parts of the annual report and accounts, in particular the viability statement, business model, strategy, KPIs and the risk reporting in the financial statements?
- Do the mitigating activities include specific information that allows the reader to understand the company's response?

Investors are unanimous that understanding those principal risks faced by a company is important both before making an investment and during the holding of that investment. A change in risk faced by a company is one factor that may cause an investor to change the size of their shareholding.

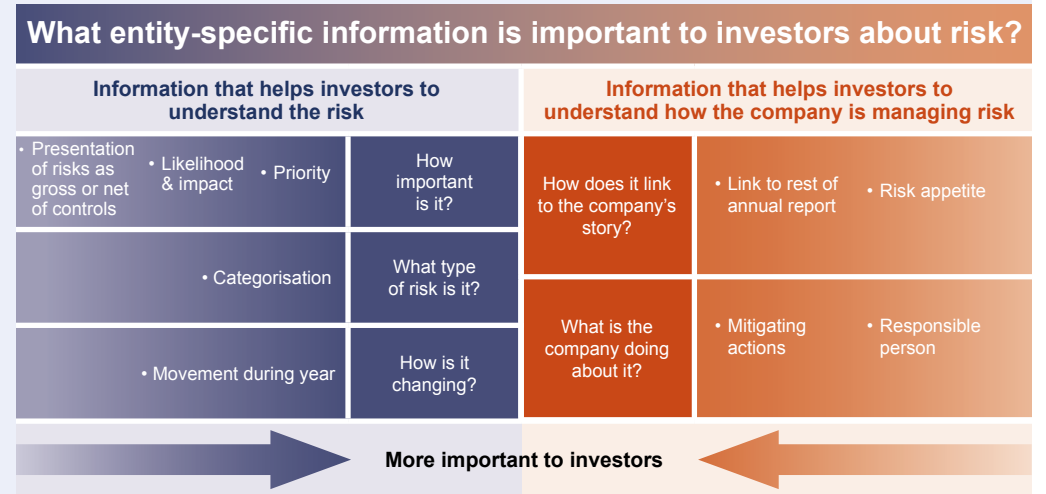
Investors see the annual report as a reliable source of information that forms a part of the suite of information (including, for example, investor presentations) used to assess the risks of a company. Investors like the annual report to have good linkage between sections, and for relationships between the key disclosures to be clearly explained.

Since the financial crisis there has been an increased focus on risk management; in response, the reporting of principal risks has become more comprehensive. In more recent times there have also been calls for directors to demonstrate further how they have promoted the success of a company and in doing so how its business model remains relevant and sustainable. Investors agree that the reporting of principal risks and better engagement with companies has improved their understanding of how the board identifies and manages risk to protect the sustainability of the company. They also understand that risk management is dynamic, and requires ongoing attention. Investors highlight the information around the risk assessment process as one area of disclosure that helps them to understand better why the company is comfortable with the principal risks disclosed.

The overall challenge for companies is getting an appropriate balance of disclosure. There is inherent tension between the desire to provide succinct and useful information to investors, and the pressure to disclose a list of principal risks which does not give away any competitive advantage, and which may result in unspecific and excessive disclosure. Companies have processes in place which gather risk information from all levels of the organisation so as to ensure that their disclosures are complete – the combination of a ‘top down’ and ‘bottom up’ approach is intended to ensure that principal risk disclosures are accurate.

## Attributes of good principal risk disclosure

All investors are looking for principal risk reporting that is specific to the company, avoiding boilerplate disclosure and jargon. Investors seek to understand both the principal risks identified by the company and how the company is managing those risks. They gain confidence in management when risks are clearly linked to the business model, show any changes in risk year on year and give some indication of the potential impact of risks occurring. The graphic below summarises key information that investors have told the Lab they are looking for companies to provide in their principal risk disclosures.



## Viability statement reporting

### Quick questions for management on their viability statement disclosures

- Does the disclosure differentiate between the directors' assessment of long term prospects and their statement on the company's viability?
- When disclosing the long-term prospects has the board considered their stewardship responsibilities, previous statements they have made, especially in raising capital, the nature of the business and its stage of development, and its investment and planning periods?
- Does the viability statement disclose any relevant qualifications and assumptions when explaining the directors' reasonable expectation of the viability of the company?
- Is the link between the viability statement and principal risks clear, particularly in relation to the scenario analyses?
- Are the stress and scenario analyses disclosed in sufficient detail to provide investors with an understanding of the nature of those scenarios, and the extent and likelihood of mitigating activities?

The Sharman Inquiry was initiated following concerns arising during the financial crisis that companies were not adequately considering their long-term viability. Following the outcome of the inquiry, the viability statement was introduced to the UK Corporate Governance Code ("the Code") in 2014 as a means of requiring directors to report annually on this.

Companies and investors are clear that viability is a concept which is inherent to the decisions that each of them make. For companies, their continuing existence and growth is dependent on the sustainability of their business model and strategy; their sustainability, as well as their resilience to risk, is a key consideration for boards. For investors, investment decisions are determined, at least in part, by the confidence they have both in the sustainability of the business model and in those who lead the company.

It is clear that for most companies the introduction of the viability statement has resulted in greater focus on risk management at board level. Performing stress and scenario analyses has improved decision making and helped companies determine their risk appetite. Investors encourage this and support companies taking appropriate risks if they are well considered and managed.

However, the value of this greater focus is often not reflected in the viability statement disclosures themselves. Investors are looking for companies to explain the long-term prospects of the company more clearly. The current practice is often that viability statements are prepared as longer term going concern statements with a focus on liquidity rather than as a means to communicate how the company will remain relevant and solvent in the long-term and be able to adapt to emerging risks.

## Two-stage process in developing a viability statement



The Code envisages a two-stage approach to the viability statement. The directors should firstly consider and report on the prospects of the company taking into account its current position and principal risks. Secondly, they 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.

Investors are not necessarily looking for a viability statement which covers the period over which they assess their investments. They are encouraging companies to consider their prospects over the longer term relative to their specific business. They understand that the directors must have a reasonable expectation which covers the period over which they state viability, and many companies have chosen a period that is limited to a medium-term strategic period.

While the Code suggests that the time period for the assessment of prospects and the statement should be the same, many investors would like more information about the risks and prospects of a company over a longer time period consistent with the company's investment and planning periods (the first stage) even if the statement (the second stage) is limited to a shorter period.

Investors also find details of the stress or scenario analyses that have been performed to be very useful in providing information on the company's resilience to risk. These should include details of the extent and likelihood of mitigating activities.

## List of examples

The lists below contains examples of how those companies participating in this project have applied reporting practices that investors are looking for in risk reporting and viability statements.

Attribute of risk reporting	Page	Company
Categorisation of principal risks	13	Aberdeen Asset Management PLC
The priority of principal risks	13	Lonmin plc
Movement in principal risks	14	Daily Mail and General Trust plc
Linkage to other parts of the annual report	15	Smith & Nephew plc
Likelihood & impact	16	Vodafone Group plc
Risk appetite	17	Smith & Nephew plc
Presentation of risks as gross or net of controls	17	J Sainsbury plc
Responsible party & mitigating activities	18	Ashmore Group plc
Brexit, cyber and climate change	19	Vodafone Group plc

Attribute of viability statement	Page	Company
Audit committee considerations on the viability statement	24	Vodafone Group plc
Application of the two-stage approach	25	Equiniti Group plc
Stress and sensitivity analysis	26	J Sainsbury plc

# Project introduction

## Project initiation

Since the 2008-09 financial crisis there has been an increasing focus on how boards of companies manage risk and assess their viability. Investors are also increasingly focused on how directors promote the success of a company and how they manage risks that might threaten this success. The Lab is undertaking a series of projects which seek to explore the areas of most interest to investors and consider where companies face challenges in deciding what disclosures to make and how best to present them.

Business model reporting was the first in this series, because establishing views on good business model reporting provides the foundation for the strategic report as a whole, and in particular on how the company considers risk and viability.

The Lab published its report on Business model reporting in 2016 and commenced this project on Risk and viability reporting in May 2017. During this project the Lab has also considered the impact of the revisions to the UK Corporate Governance Code (“the Code”) in 2014 which introduced the requirement for directors to carry out a robust assessment of risk and assess the prospects of the company sufficient to make a statement about its viability.

## The scope of the project report

This report examines the views of those companies and investors participating in this project on the key attributes of principal risk and viability reporting, their value and use. It also provides illustrative examples of reporting favoured by investors.

In this report we use the following definitions:

- Principal risk and mitigating action disclosures – these are the disclosures made by a company applying the Code.
- Viability statement - the statement made by companies to assess their prospects and viability to comply with provision C.2.2 of the Code.

Views were obtained from 25 representatives from companies and 27 members of the investment community. Companies range in size from FTSE 100 to AIM, and participants include members of finance, risk, company secretarial and investor relations teams. Investment community participants include retail investors, buy-side and sell-side analysts, fund managers, fixed income investors, and credit rating agency representatives. The Lab also carried out a survey of approximately 200 private investors. See the ‘Participants and process’ section for further details.

## Business model reporting

Key findings from the Business model reporting project which link through to the key findings from this project are:

1. Improvement could be made in linking business model reporting to other areas of the annual report (see diagram below).
2. Investors find it helpful when changes made to a company’s strategy since the last annual report are clearly explained.
3. Language should be plain, clear, concise and factual and presentation should be fair, balanced and understandable.
4. Information is important both at the initial investment stage and for investors’ ongoing monitoring and stewardship responsibilities.
5. Many companies express concern that disclosure of their competitive advantage is commercially sensitive and could jeopardise the company’s prospects. However, investors believe companies can balance commercial sensitivity with providing sufficient disclosure to enable them to understand what differentiates the company and how the board is responding to emerging risks.





## The regulatory context

The financial crisis raised questions about the extent to which companies were managing going concern and liquidity risk. As a consequence some regulations and guidance were introduced that are relevant to the management and disclosure of risk and viability. These are set out below:

### The Sharman Inquiry and revisions to the Code

The primary purpose of the Sharman Inquiry was to understand whether going concern and liquidity issues were being appropriately managed and reported.

In June 2012, it published its report<sup>1</sup> which included recommendations that:

- encouraged companies to move away from a model where disclosures about going concern risks are only highlighted when there are significant doubts about a company's survival; and,
- the going concern assessment should be integrated with the directors' business planning and risk management processes and include a focus on both solvency and liquidity risks, considering the possible impacts on the business over the longer term.

Following these and other recommendations, the Code was updated in 2014 to include the following new requirements:

- 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.

- 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.

The intention of C.2.2 is for companies to apply the provision in two stages, firstly for directors to assess the prospects of the company and secondly to make a statement of its viability.

The provision in the Code on the going concern confirmation was updated in 2014 to clarify that this is a separate statement confirming the choice of accounting policy.

### FRC Guidance on Risk Management, Internal Control and Related Financial and Business Reporting (2014)

The FRC also issued Guidance on Risk Management, Internal Control and Related Financial and Business Reporting in 2014. This provides further guidance on risk and viability reporting, including a section on the 'Long Term Viability Statement'.

### The Listing Rules

The Listing Rules were updated in October 2015 to require a statement by the directors on their assessment of the prospects of the company (containing the information set out in provision C.2.2 of the Code) prepared in accordance with the 'Guidance on Risk Management, Internal Control and Related Financial and Business Reporting' published by the Financial Reporting Council in September 2014.

### Companies Act 2006

The Companies Act 2006 414C(2)(b) requires that the strategic report contains a description of the principal risks and uncertainties facing the company.

This requirement applies to a wider range of companies than the Code, including UK AIM and many private companies. In PN 130, the FRC commented: 'As the purpose of the business review is to inform members of the company and to help them assess how the directors have performed their duty to promote the success of the company, [we] believe that a board should state how the company manages its principal risks and uncertainties.' This report, and especially the section on principal risks and uncertainties in the annual report. For the purposes of this report, the Lab refers to 'principal risks'.

### FRC Guidance on the going concern basis of accounting and reporting on solvency and liquidity risks

This Guidance is intended to serve as a proportionate and practical guide for directors of non-Code companies. It brings together the requirements of company law, accounting standards, auditing standards, other regulation and existing FRC guidance relating to reporting on the going concern basis of accounting, and solvency and liquidity risks, and reflects developments in the FRC's thinking as a consequence of the Sharman Inquiry.

<sup>1</sup> <https://www.frc.org.uk/getattachment/870d840d-2455-47bb-949e-d7f29c32b506/The-Sharman-Report-final-0311111.pdf>

## FRC Guidance on the Strategic Report

The FRC Guidance on the Strategic Report supports the legislative requirements in respect of the Strategic Report.

The FRC is currently in the process of revising its Guidance to reflect the enhanced disclosures that certain large companies are required to make in respect of the environment, employees, social matters, respect for human rights and anti-corruption and anti-bribery matters.

The Guidance also encourages all companies to disclose information on how boards have considered broader stakeholders in fulfilling their duty to promote the success of the company.

## Risk factors for companies registered with the SEC

UK companies that are registered with the US Securities and Exchange Commission ("SEC") under the US Securities and Exchange Act of 1934 (usually because they have securities listed on exchanges in the US) are required to make an annual filing (Form 20-F if the company is a "foreign private issuer"). The requirements for the disclosures to be included in a Form 20-F include specific risk reporting requirements, which are different (in their terms and objective) from the requirements under the Code for risk reporting in the annual report.

The Code requires companies to include in their annual report a description of the principal risks facing the business and explain how they are being managed or mitigated. The objective of the annual report is to provide the shareholders of the company (and other stakeholders) with "the information necessary for shareholders to assess the company's position and performance, business model and strategy".

The Form 20-F calls for prominent disclosure of risk factors that are specific to the company or its industry and an investment in the company's shares in a section headed "Risk Factors." This requirement is focused on the risks of investment and typically results in a longer list of risk factors than the principal risks required to be disclosed in an annual report, as set out in the Code. Another important distinction is that the SEC does not allow disclosure of mitigating actions, a further illustration that the objectives of the two apparently similar requirements are different.

Companies which are subject to both sets of requirements adopt different approaches to deal with these reporting requirements. Some companies include both disclosures in one document, which fulfils the function of both the annual report and the 20-F, with separate sections describing principal risks (as required by the Code) and risk factors (as required by Form 20-F). Other companies prepare two separate documents, each containing the disclosure required to satisfy the different requirements applicable to it.



# Principal risk reporting

## Importance of principal risk reporting

During its Business model reporting project, the Lab concluded that investors used business model reporting as part of their initial investment appraisal process, monitoring the investee company's performance and fulfilling their stewardship responsibilities. Investors in this project similarly consider the reporting of principal risks to be an important factor in their decision making process. Having an understanding of the principal risks faced by a company is important, both before making an investment and during the holding of that investment. Changes in risks faced by a company are one factor which may cause an investor to change the size of their shareholding or bondholding.

When researching a potential investment in a company, investors consider the annual report to be a reliable source of information on principal risks and mitigating activities. Even when they have invested in a company or sector for a long period of time, investors will still review the principal risk disclosures in the annual report in order to evaluate their own views on the company's risk and to understand how the board is managing those risks.

However, the annual report is not the only source of information on risk. Investors, both institutional and retail, use a variety of sources, such as:

- Investor presentations (usually available via the company's website)
- Newspapers / media
- Prospectuses
- Sell-side analyst reports

Institutional investors and intermediaries (e.g. equity analysts, ratings agencies) also have access to:

- In-house sector specialists
- Company board and management

The principal risk and risk management disclosures themselves also provide comfort to investors that the company has appropriate risk management processes in place. Where disclosures are inconsistent with investor expectations, institutional investors seek to engage with management in order to improve their understanding. Retail investors have far less access to management and our survey indicates that where risk disclosures appear inconsistent with their expectations, they are less likely to invest.

*62% of the retail investors surveyed say that their investment decisions are influenced by the principal risk disclosures in the annual report and accounts*

Source: Lab survey of retail investors

Investors confirm that they read the principal risk disclosures in the context of the annual report and accounts as a whole. Although there is variety in how the annual report is consumed, with some reading it from start to finish and others focusing on specific areas, investors stress the importance of consistent information and clear linkage within the annual report. Clear linkage is also helpful in reducing repetition of information.

Although many investors think that reporting of principal risks by companies can be improved, most did comment during interviews that risk disclosures have become more helpful over the period since the financial crisis. Investors have noted during their engagement with companies that the board and management are now more focused on and better able to explain how they manage risk.

Companies report that risk has become more integral to strategic decisions, while the process by which they assess viability has resulted in a more uniform approach to assessing the impact of principal risks.

Together with the reporting changes introduced through the Code, this has resulted in companies disclosing more information around risk management systems and principal risks.

Companies and investors agree that risk is integral to their engagement, although it is unlikely that investors will use the principal risk disclosures in the annual report as the basis for a line of enquiry (unless they fundamentally disagree with the risks disclosed). Rather, questions around risk are included in wider discussions on strategy, business model and future performance. It is therefore important that disclosures on principal risks are given context and linked to relevant areas in the annual report, as this allows investors to understand how the company is addressing these issues.

### Lab Comment

The Lab reviewed how the principal risk disclosures of those companies participating in this project had developed. The average length of the risk disclosure increased from 2.8 pages in 2011/12 to 5.5 pages in 2016/17.

Developments include:

- Additional information on the risk management process.
- Greater contextualisation of risk. For example:
  - ✓ risk movement
  - ✓ categorisation of risk
  - ✓ identification of the risk owner (e.g. relevant committee)
  - ✓ links to other parts of the annual report
  - ✓ diagrams and visual aids (e.g. heat maps)

## What challenges do companies face when reporting their risks?

The main challenge that companies identify is how to report succinct information on principal risks that is of most use to the reader. The basis for the principal risk disclosure is usually the risk register, which often includes risks at a disaggregated level. Aggregating a substantial number of risks, often across a business which has several different segments, and still ensuring that the disclosure is sufficiently insightful, can present a challenge.

Companies are also concerned that not having a 'complete' set of principal risks could result in challenge from investors, even when those risks are general risks faced by any company operating in that sector or geographical location. Companies can be cautious about the approach taken and many will compare competitors' annual reports in order to ensure that their own disclosures are consistent.

*"I suspect that companies are putting together their risk report, then looking at what everyone else in the sector is doing and ensuring that they have everything. There aren't that many companies that are prepared to go out there with something different – it is really hard for them."*

Investor

Companies are also wary that the reporting of principal risks in too much detail may give away a competitive advantage.

The overall challenge for companies is getting an appropriate balance of disclosure. There is inherent tension between the desire to provide succinct and useful information to investors, and the pressure to disclose a list of principal risks which does not give away any competitive advantage, and which may result in unspecific and excessive disclosure.

Investors highlight the information around the risk assessment process as one area of disclosure which helps them to understand better why the company is comfortable with the principal risks disclosed. However, this is also cited as one disclosure which contains 'boilerplate' information and excessive jargon. Two examples of disclosure which provide useful and specific information on internal control and risk management systems are included on this and the following page.

During the course of this project, both companies and investors have discussed ways in which reporting can address these challenges. The diagram (pg. 12) and extracts from annual reports and accounts provide guidance about the ways in which companies can disclose relevant and specific information which investors find useful.

### Lab Comment

Hill & Smith provide investors with specific information on their approach but also describe enhancements in the process in the current year and what the key areas of focus are. This gives insight into how the company is thinking about and addressing risk.

### Example: Hill & Smith Holdings plc Annual Report and Accounts 2016

This process ensures that risks are not just the product of a bottom-up approach but are also examined from a top-down perspective via an integrated senior management approach, which is closely aligned with the Group's strategy. In order to enhance the Group's approach to risk generally, more work was done with the subsidiaries in terms of providing an online risk assessment reporting process during 2016, and the senior management team were instrumental in adding a top-down perspective to the Group's principal risks.

The approach, enhanced throughout 2016, has allowed the Board to carry out a robust assessment of the principal risks and uncertainties that might threaten the Group's business model, future performance, solvency and liquidity and this has led to a more strategic focus on our principal risks and uncertainties as explained on page 32 to 34.

Key focus for 2017

- Continued assessment of the principal risks facing the Group and its subsidiaries including those that might threaten the Group's business model, future performance, solvency and liquidity;
- Further work with the subsidiaries to develop business unit risk registers and to share best practice;
- Improved bottom-up reporting on principal risks and uncertainties and enhancing the Board conversation; and
- Further development of the Risk Committee and top-down risk assessment processes.

*"The more honest and open a company is on risk, the more confident we're going to be that they're looking at the issues in the right way and have an intelligence around the table considering it. If it is all good news, you'd worry that they are burying things. Honesty has to be the best starting point."*

Investor

*"One of the problems is excessive business jargon and too technical aspects of risk management which I am not sure most users / readers of annual reports would necessarily get."*

Investor

Example: UBM plc Annual Report and Accounts 2016

**Top-down review**

The Executive Committee, Head Office and the divisions review the Group and divisional risk maps and compare them with the existing and future characteristics of our products, services and customers. This analysis is presented to the Board bi-annually. We continue to use a financial modelling process, based on an enhanced version of that used in 2015, to test the resilience of the business in relation to its solvency and liquidity.

**Bottom-up review**

A full risk assessment and identification exercise is carried out twice a year. The Group Risk function participates with the divisions and business functions to analyse impacts and likelihoods. Similar risks across different divisions are monitored to assess any changes on an aggregate basis globally. The Group Risk function continues to review its policies and procedures to ensure that they support UBM's strong controls framework and operational needs.

**Risk management process**

The graphic below illustrates our approach to identifying and managing risk. UBM employs both a top-down and a bottom-up approach. Risk identification follows a standard framework to assess impact and likelihood. Risks are ranked in order to better direct resources to those which have a higher potential impact. Risks which reach a materiality threshold have specific mitigation plans in place to reduce or remove those risks.

With a focus on continuous improvement, the bi-annual risk reviews critically assess the effectiveness of the mitigation and recommend enhancements.

**Developments in risk management in 2016**

UBM continued to enhance its risk management policies and procedures during the year.

- In addition to the Audit Committee receiving divisional risk presentations, the Board also considered a number of deep-dive risk reports including an analysis of cyber risk, the implications of Brexit and the robustness of UBM's capital structure.
- A review of UBM's major venue contracts, focused on contractual risk, was completed.
- Divisional materiality thresholds and risk maps were introduced.
- Risk workshops were held with divisional management to support the quality of risk identification and assessment at a local operating level and to enhance engagement and understanding across the business.
- UBM's risk scenario modelling was carried out to include testing the resilience of the organisation from the perspectives of liquidity and solvency. This was extended to include reverse stress testing and aggregation.

**How many principal risks should a company disclose?**

There were differences of view from the investors in this project. Some investors like to see a short list of five to ten principal risks, while others welcome a more comprehensive list of risks which may include emerging risks.

Of greater importance to investors is the quality of the disclosure. All investors agree that principal risk reporting is best when it is specific to the company and allows them to identify risks in sufficient detail to help them make an informed assessment of how they might impact the business model of the company. Several cite risks to reputation as being key, and not always well reflected in disclosure.

Additionally, investors have their own views on the general economic and political landscape, and therefore they find the disclosure of general macroeconomic, geopolitical or industry-wide risks less useful than company-specific risks. However to omit such risks would be misleading, and of most importance is how companies are responding to those risks.

*The descriptions of the principal risks and uncertainties facing the entity should be specific so that a shareholder can understand why they are material to the entity.*

Source: FRC Guidance on the Strategic Report 2014

**Lab Comment**

UBM provide a succinct description of their approach to risk management and, like Hill & Smith, provide some details of enhancements to their approach to risk management.

They also provide specific examples of how they have put this approach into practice.

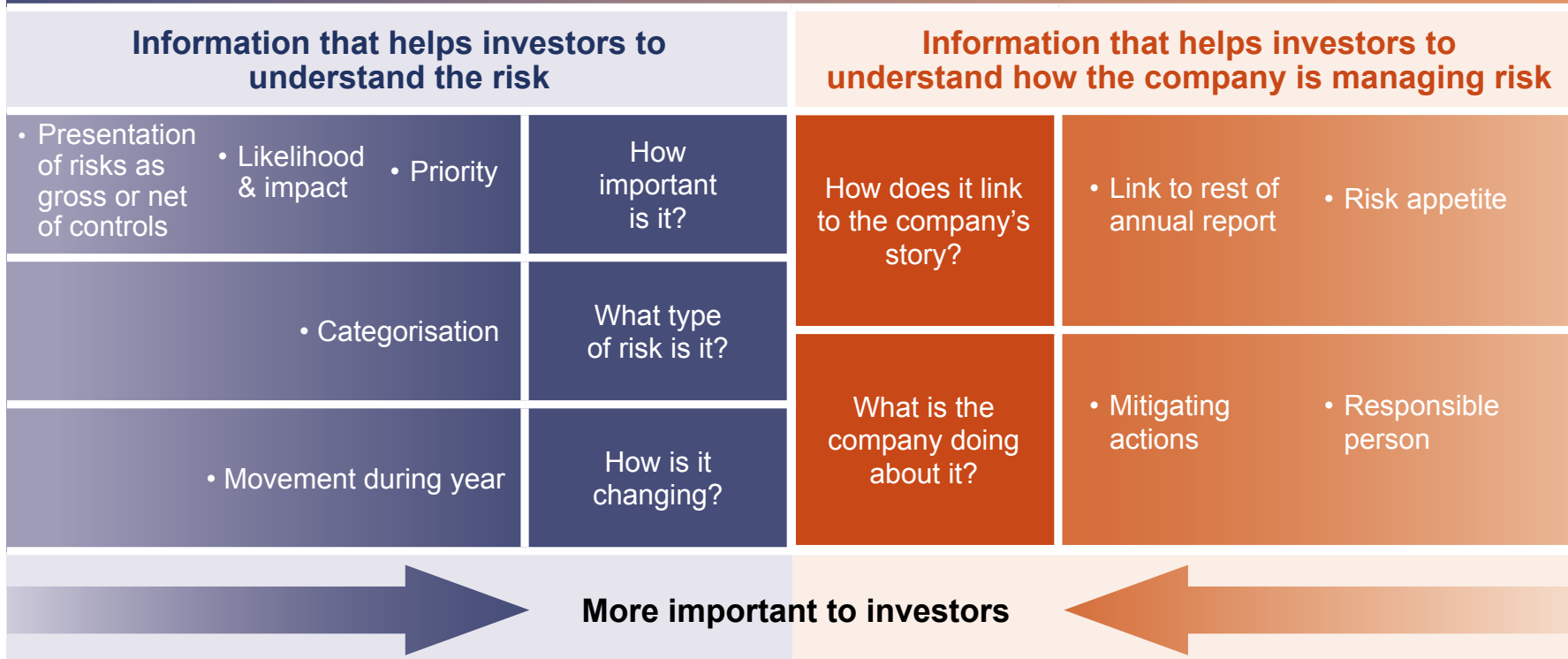
## What risk characteristics / disclosures do investors tell us they like?

We asked investors their views on the presentation of principal risk disclosures. From this, we have compiled a list of disclosure characteristics, with published examples taken from the annual reports of companies participating in this project.

### FRC Annual Review of Corporate Reporting 2015/16

The FRC reported that the introduction of the strategic report has provided a clearer focus on the links between business models, strategies, risks and performance, and led to an improvement in narrative reporting generally. However, more can be done to improve narrative reporting, including: (i) providing information on the company, the environment in which it operates and the risks it faces that is specific to the company and not explained in general terms; and (ii) explaining the links between information in the annual report, such as objectives, KPIs and risks.

## What entity-specific information is important to investors about risk?



## Categorisation of principal risks

Some form of categorisation of principal risks is useful for investors, and can provide insight into how the board are thinking about these risks. Several investors stated that clear categorisation of principal risks to identify those which are company specific and those which are more general (e.g. industry) risks would be helpful, especially as this aids the comparison of principal risks across companies.

### Lab comment

Aberdeen Asset Management have used categories of principal risks to identify the level of influence they have over each, providing investors with some level of information on how specific the risk is to Aberdeen Asset Management as a business.

## The priority of principal risks

Most investors seek to understand the priority placed by the directors on each principal risk as it provides insight into their judgement. Several investors told us that where there is no obvious ordering of risks (for example, by category), they would assume that the first risk on the list is the most important to the company. It is important for disclosures to be clear on the means of prioritising their principal risks, so as to avoid any misunderstanding of where the company is focusing its efforts in managing risks.

### Lab comment

Lonmin rank their principal risks on net basis, providing investors with clarity around how the board sees the risks.

### Example: Aberdeen Asset Management PLC Annual Report and Accounts 2016

#### Operational risks

Operational risk is the risk of loss resulting from inadequate or failed internal processes, systems, human factors or due to external events. Operational risk can manifest itself in various ways, including business interruptions, inappropriate behaviour of employees (including fraud), failure to comply with applicable laws and regulations or failure of vendors to perform in accordance with their contractual arrangements. These events could result in financial losses, litigation and regulatory fines, as well as other damages to the Group.

#### Strategic and business risks

Strategic risks are those that arise from decisions taken by the Board and senior managers concerning our strategy. They relate to how we are positioned in the asset management industry as a whole, rather than just a particular part of the business.

Business risks materialise due to poor business implementation or a failure to respond appropriately to internal or external factors.

#### Financial and capital risks

Financial and capital risks arise from movements in the financial markets in which we operate and inefficient management of capital resources.

### Example: Lonmin plc Annual Report 2016

These risks have been ranked on a residual basis according to the magnitude of potential impact, probability and taking into account the effectiveness of existing controls. The risks represent a snapshot of the Company's current risk profile. This is not an exhaustive list of all risks the Company faces. As the macro environment changes and country and industry circumstances evolve, new risks may arise or existing risks may recede or the rankings of these risks may change.

- |                                 |   |
|---------------------------------|---|
| 1. Operational execution        | 6. Utilities  |
| 2. Price and market volatility  | 7. Changes to the political, legal, social and economic environment, including resource nationalism |
| 3. Employee and union relations | 8. Lack of geographical and product diversification   |
| 4. Safety performance           | 9. Loss of critical skills  |
| 5. Community relations          |   |



## Movement in principal risks

Investors are keen to understand the reasons why the assessments of principal risks have changed in the year. Disclosures which show only a direction of travel were commented on less positively than those which explain the context and cause of the movement. In general, investors believe that once a company has identified its principal risks, it is unlikely that there will be substantial changes year-on-year. However, where a company judges a risk to no longer be a 'principal' risk, investors would appreciate a short explanation.

### Lab comment

Daily Mail and General Trust outline the changes in principal risks early in the disclosure, thereby drawing investors' attention to the changes they can expect to see.

### Example: Daily Mail and General Trust plc Annual Report 2016

#### Changes in principal risks during the year

Two principal risks disclosed last year, 'Internal investment' and 'New product launches', have been combined this year due to their overlap. These are now described in a new risk called 'Success of new product launches and internal investments'. In recognition of the results of the recent referendum on the UK membership of the European Union (EU) and wider macroeconomic volatility, a new principal risk, 'Economic and geopolitical uncertainty', has been added and the potential impact on DMGT is outlined below. At this early stage, due to the diverse nature of our portfolio, we believe that the impacts will be manageable, however, we will continue to monitor these carefully as they develop and adapt accordingly.

*"Risk movement information would be useful – risks are not static. The trick, from a fund manager's point of view, is the ongoing, iterative process about the information on the organisation. They would expect the principal risks to move up and down in importance to the business. Being able to provide some information about certain issues on the horizon would be useful."*

Investor



**Linkage to other parts of the annual report**

As discussed in Business model reporting, clear linkage within an annual report is desirable. The business model or strategy, not the principal risks, are considered the base from which to link other parts of the annual report, and therefore it is important to show how principal risks fit into those disclosures.

Investors commented positively on disclosure which explains the link. Some investors also highlight consistency with other reports, e.g. the sustainability report, as a key consideration for companies.



**Lab comment**

Investors want to be able to understand the relationship between different disclosures. Smith & Nephew link to information which they believe is key to understanding the company.

**Lab comment**

Investors identify clear linkage as a key component of good reporting. The Lab’s Business model report used the above diagram to highlight the relationship between certain key disclosures in the annual report and accounts, and the example below provides a suggestion of how principal risks can be linked to strategy. Clear linkage helps to avoid repetition of information and assists the board in their assessment of whether the annual report and accounts are fair, balanced and understandable.

*41% of FTSE 350 companies link principal risks to strategic objectives*

Source: Accountability in changing times,<sup>2</sup> PwC

**Example: Smith & Nephew plc Annual Report 2016 (Strategy)**

**PRICING AND REIMBURSEMENT**

Our success depends on governments providing adequate funding to meet increasing demands arising from demographic trends. The prices we charge are therefore impacted by budgetary constraints and our ability to persuade governments of the economic value of our products, based on clinical data, cost, patient outcomes and comparative effectiveness.

In implementing innovative pricing strategies, we have a moderate to high tolerance for risk and are willing to accept certain risks in pursuit of new business opportunities.

**Link to strategy**

Our Strategic Priorities to ‘Build a Strong Position in Established Markets’ and to ‘Focus on Emerging Markets’ depends on our ability to sell our products profitably in spite of increased pricing pressures from governments.

**Actions taken by management**

- Developing innovative economic product and service solutions for both Established and Emerging Markets, such as Syncera®.
- Maintaining an appropriate breadth of portfolio and geographic spread to mitigate exposure to localised risks.
- Incorporating health economic components into the design and development of new products. Emphasising value propositions tailored to specific stakeholders and geographies through strategic investment and marketing programmes.
- Holding prices within acceptable ranges through global pricing corridors.

**Examples of risks**

- Reduced reimbursement levels and increasing pricing pressures.
- Reduced demand for elective surgery.
- Lack of compelling health economics data to support reimbursement requests.
- Trading margin will be impacted when the currencies in our main manufacturing countries (US, UK, Costa Rica and China) move against the currencies in the rest of the world where our products are sold.

<sup>2</sup> <https://www.pwc.co.uk/audit-assurance/assets/pdf/ftse-350-reporting-opportunities.pdf>

**Likelihood & impact**

Many investors feel that information on the likelihood and possible impact of principal risks provides useful insight into the environment in which a company operates and, when provided by multiple companies in a sector, allows for a detailed assessment of the risk profile of each.

The most common form of disclosure for this information is a risk heat map. Some investors think these can be useful, although this depends on how specific the company can be in quantifying the information included in the diagram. Many investors comment that current practices in the use of heat maps do not provide sufficiently precise information to be of much benefit and would prefer some narrative description to provide further explanation.

When companies do use risk heat maps, they should be clear as to whether principal risks are reported as gross or net of mitigating actions.

Some investors are very positive about the idea of quantifying principal risks, although recognise that this may not be practical as some risks are difficult to quantify (and some may be unquantifiable altogether). One suggestion is that it would be helpful to understand which segments of the business a principal risk might impact, and the relative size of those segments.

**Lab comment**

Investors like the clarity of Vodafone’s disclosure, which provides a heat map but also identifies and explains changes in the risk profile and enables easy identification of each risk.

**Example: Vodafone Group plc Annual Report 2017**

**Our principal risks**

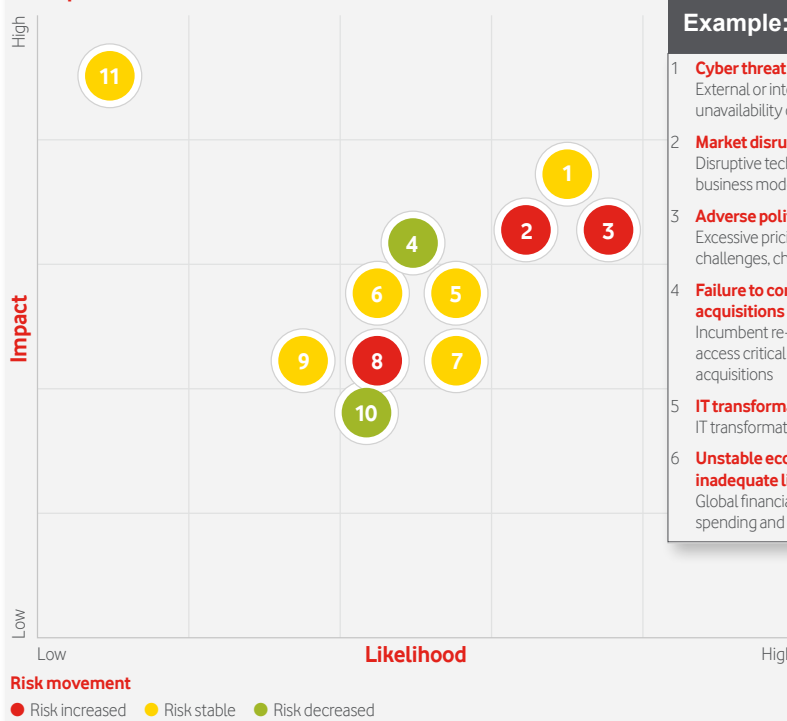
We undertake a two stage process to identify our principal risks. All local markets and entities identify their priority risks which are consolidated into a Group-wide view. We then conduct interviews with over 40 senior leaders to gain their insights. The results of both exercises are consolidated to produce our principal risks, as reported here.

**Key changes in the year**

Our risk profile remains stable relative to last year, with the following key changes:

- The two technology risks are now considered separately, as the causes for these are different (now risks 5 & 7).
- The Customer eXperience eXcellence (‘CXX’) risk now focuses on digital capability (risk 8).
- The adverse political measures risk now includes upcoming 5G auctions (risk 3).

**Principal risks**



**Example: Vodafone Group plc Annual Report 2017**

- |   |  |
|---|--|
| 1 <b>Cyber threat and information security</b><br>External or internal attack resulting in service unavailability or data breach                                | 7 <b>Technology failure</b><br>Failure of critical IT, fixed or mobile assets causing service disruption   |
| 2 <b>Market disruption</b><br>Disruptive technology, changes in competitor business models, lack of agility   | 8 <b>Failure to deliver on digital transformation and CXX</b><br>Failure to create a differentiated, digital customer experience                     |
| 3 <b>Adverse political and regulatory measures</b><br>Excessive pricing of 5G licences, tax authority challenges, changing national politics                    | 9 <b>Non-compliance with legal and regulatory requirements</b><br>Non-compliance with laws, regulations, network licence requirements                |
| 4 <b>Failure to converge and integrate acquisitions</b><br>Incumbent re-monopolisation, failure to access critical content, inability to integrate acquisitions | 10 <b>Failure to deliver major Enterprise contracts profitably</b><br>Failure to meet commitments and/or deliver at appropriate profitability levels |
| 5 <b>IT transformation failure</b><br>IT transformation failures impacting NPS  | 11 <b>EMF health related risks</b><br>EMF found to pose health risks causing reduction in mobile usage or litigation                                 |
| 6 <b>Unstable economic conditions/ inadequate liquidity</b><br>Global financial crisis reducing consumer spending and ability to refinance                      |  |

**Risk appetite**

Both investors and companies agree that risk appetite is a very difficult concept to succinctly articulate in the principal risk disclosures. Companies say they inherently think about risk appetite when making strategic decisions, and some investors say that it is possible to get a feel for a company’s risk appetite from the annual report without having an explicit statement attempting to explain or quantify it.

For companies who want to provide some information on risk appetite, investors say it is important to provide a basis for the amount of appetite they have.

**Lab Comment**

Investors expect companies to take certain risks in order to take advantage of opportunities. They find it helpful to understand how companies distinguish those risks that they are willing to take (e.g. in pursuit of innovation) and those where there is low tolerance (e.g. product safety). They also want to be able to understand the relationship between different disclosures.

**Presentation of risks as gross or net of controls**

The Code requires companies to disclose principal risks and uncertainties and how these are being managed or mitigated. In the disclosures around this information (e.g. risk heat map, likelihood and severity discussions), some companies prefer to present principal risks on a ‘gross’ basis (i.e. before controls) as this is felt to be less judgmental.

Investors did not express a clear preference either way. The emphasis from investors was that companies need to be clear about which basis they are using when disclosing information around principal risks.

**Example: Smith & Nephew plc Annual Report 2016**

**PRODUCT INNOVATION, DESIGN AND DEVELOPMENT**

The medical devices industry has a history of rapid new product innovation. The sustainability of our business depends on finding and developing suitable products and solutions to meet the needs of our customers and patients to support long-term growth.

In acquiring and developing new technologies and products, we have a moderate to high tolerance for risk and are willing to accept certain risks in pursuit of innovation, whilst having a very low tolerance for product safety risk.

**MERGERS AND ACQUISITIONS**

As the Company grows to meet the needs of our customers and patients, we recognise that we are not able to develop all the products and services required using internal resources and therefore need to undertake mergers and acquisitions in order to expand our offering and to complement our existing business. In other areas, we may divest businesses which are no longer core to our activities. It is crucial for our long term success that we make the right choices around acquisitions and divestments.

In acquiring new businesses and business models, we have a moderate to high tolerance for commercial risk and are willing to accept certain risks in pursuit of new business. However, we have an extremely low tolerance for regulatory or compliance risk.

We have a well-defined cross-functional process for managing risks associated with mergers and acquisitions that is subject to scrutiny from executive management and the Board of Directors.

**Example: J Sainsbury plc Annual Report and Financial Statements 2017**

The gross risk movement from prior year for each principal risk and uncertainty has been assessed and is presented as follows:

- No change
- ↑ Increased gross risk exposure
- ↓ Reduced gross risk exposure

**Lab comment**

Sainsbury clearly identify for investors the fact that the movement in risk is presented gross.

**Responsible party & mitigating activities**

Investors are interested in how the board responds to principal risks. Companies should pay attention to how they describe the mitigating activities. One way of illustrating that response is by disclosing the party responsible for each principal risk. Those investors interested in this information say it provides insight into governance over principal risks. Where provided, it is important that this information is consistent with other disclosures around the risk management and internal control systems.

**Lab Comment**

Investors like the clear identification of where responsibility for principal risks lies in the organisation.

*“Individual ownership gives you more of a shape of the process and confidence that there is a line of accountability, that the board has a chain to pull.”*

Investor

**Example: Ashmore Group plc Annual Report 2017**

**Client risks** (Responsibility: Product Committee and Group Risk and Compliance Committee)

- Inappropriate marketing strategy and/or ineffective management of existing and potential fund investors and distributors
- Inadequate client oversight including alignment of interests
- Frequent and regular Product Committee meetings review product suitability and appropriateness
- Experienced distribution team with appropriate geographic coverage
- Investor education to ensure understanding of Ashmore investment themes and products
- Monitoring of client-related issues including a formal complaints handling process
- Compliance and legal oversight to ensure clear and fair terms of business and disclosures, and appropriate client communications and financial promotions

**Treasury risks** (Responsibility: Chief Executive Officer and Group Finance Director)

- Inaccurate financial projections and hedging of future cash flows and balance sheet, as well as inadequate liquidity and regulatory capital provision for Group and its subsidiaries
- Defined risk appetite and ICAAP demonstrates excess financial resources
- Group Liquidity and FX hedging policies
- Seed capital is subject to strict monitoring by the Board within a framework of set limits including diversification

## Brexit, cyber and climate change

The FRC has highlighted the need for companies to consider a broad range of factors when determining their principal risks, including the impacts of cyber-crime, climate change and Brexit. The intention was for such risks to be part of the consideration for determining a company's principal risks.

Investors consider that companies should only include these as principal risks if they are relevant. Many investors that participated in this project invest in companies for the long term and would like to see companies assess how longer term risks such as these might impact the company.

Investors find it helpful when companies have some explanation of the effect of Brexit and how they are responding to the potential impact. Investors have their own views on the potential impact of Brexit on a company, and therefore find it helpful if companies explain how they are preparing to address some of the risks that may arise.

### Example: Vodafone Group Annual Report 2017

#### Brexit implications

The Board continues to keep the possible implications of Brexit for Vodafone's operations under review. A cross-functional team, led by two Executive Committee members, has identified ways in which Brexit might affect the Group's operations. Despite the Article 50 Notice having been served, there remains insufficient information about the likely terms of the post-Brexit arrangements between the UK and the EU, as well as about any possible transitional arrangements, to draw any conclusions about the probable impact. Although we are a UK headquartered company, a large majority of our customers are in other countries, accounting for most of our revenue and cash flow. Each of our national operating companies is a standalone business, incorporated and licensed in the jurisdiction in which it operates, and able to adapt to a wide range of local developments. As such, our ability to provide services to our customers in the countries in which we operate, inside or outside the EU, is very unlikely to be affected by Brexit. We are not a major international trading company, and do not use passporting for any of our major services or processes.

Depending on the arrangements agreed between the UK and the EU, two issues that could directly affect our operations, in both cases potentially causing us to incur additional cost, are:

- creation of a data frontier between the UK and the EU: the inability to move data freely between the UK and EU countries might cause us to have to move some technical facilities, and affect future network design.
- inability to access the talent we need to run a multinational Group operation from the UK: increased controls over or restrictions to our ability to employ leading talent from non-UK markets could cause us to have to adjust our operating model to ensure that we attract and retain the best people for the roles we have.

A further, indirect, issue that could affect our future performance would arise if the Brexit process caused significant revisions to macro-economic performance in our major European markets including the UK, thus affecting the economic climate in which we operate, and in turn impacting the performance of the operating companies in those markets.

# Viability statement reporting

## What is the purpose of the viability statement?

One of the recommendations of the Sharman Inquiry was for companies 'to provide information to stakeholders about the economic and financial viability of the company and to help demonstrate the directors' stewardship and governance of the company in that respect.'

The report concluded that information supporting this 'should be specific to the entity and avoid standardised language. The directors should be free to rely on their judgement, experience and understanding of the underlying business in making their assessment and in disclosing what they believe will be most relevant to shareholders and other stakeholders.'

It also highlighted the need for consideration of solvency risk as well as liquidity risk which had previously been the focus of going concern assessments:

'The evidence we received confirmed that for many the principal focus of the going concern assessment process is on liquidity and that, outside the financial services sector, there is little focus on solvency... Solvency risk on the other hand is about the viability of the business model and the maintenance of capital. Solvency risks are therefore longer term and may be more qualitative and judgmental, whereas liquidity risks tend to be more short term and more quantitatively based.'

Companies and investors are clear that viability is a concept which is inherent to the decisions that each of them make. For companies, their continuing existence and growth is dependent on their business model and strategy, and the sustainability of these, as well as their resilience to risk, is a key consideration for boards. For investors, their decisions are determined, at least in part, by the confidence they have both in the sustainability of the business model and in those who lead the company.

## Investors' perspectives on current practice

Overall, investors want a better indication that companies are looking at the longer term. They find that few companies currently use the viability statement as a means of communicating positive messages about the long-term prospects of the company, treating it rather as an extended going concern confirmation.

While some investors agree that they engage with companies on their viability statement, few companies report that they receive questions on their statement. Of the companies that participated in this project, three reported that they had received questions on the viability statement from investors.

*"We have engaged with management on viability statements a few times. Many of them have been feeling their way a bit."*

Investor

Some investors are encouraging companies to explain how they consider longer term prospects. The Investment Association published Guidelines for Viability Statements<sup>3</sup> in November 2016, that provide suggestions for improved reporting based on the expectations of its members (see box overleaf).

Similarly, Schroders sent a letter to FTSE 100 investee companies in December 2016 noting that the majority of FTSE 350 companies had selected a three year viability statement period. The letter encourages companies to consider how they will perform through an entire business cycle, and suggests that particular attention should be paid to gearing levels, loan covenants and off balance sheet liabilities. The full letter is reproduced in Appendix A.

<sup>3</sup> <https://www.ivis.co.uk/media/12490/Guidance-viability-statements-final2.pdf>



## The Investment Association - Guidelines for Viability Statements

1. Period for the viability assessment:
  - Consider longer time horizons
  - State clearly as to why the period was chosen
  - Differentiate time horizons for prospects and viability
2. Consider prospects and risks when assessing viability
  - Consider the current state of affairs
  - Address the sustainability of dividends
  - Distinguish risks that impact performance from those that threaten operations
  - Separate prospects from viability
  - State clearly why the risks are important, and how they are managed and controlled
  - Prioritise risks
3. Stress testing
  - Disclose specific scenarios considered and likely outcomes
  - Describe specific mitigating or remedial action
  - Perform reverse stress testing
4. Qualifications and assumptions
  - Be clear on the difference
  - Ensure they are specific to the company

## Developments in Corporate Governance and Stewardship 2016

Published by the FRC in January 2017, *Developments in Corporate Governance and Stewardship 2016* analyses 89 companies from ten FTSE 350 sectors and encourages all companies to provide more constructive reporting in line with the spirit of the Code. Specific observations and suggestions for improvement include:

### Explaining clearly the rationale for their choice of timeframe

Across the ten FTSE 350 sectors there is a lack of variation in the viability period chosen. Two thirds of the sample chose three years, and the remainder mainly elected five years. The basis for the period of viability selected is the business planning/strategy period and this gives a greater level of assurance. The FRC encourages companies to provide clearer disclosure of why the period of assessment selected is appropriate for the particular circumstances of the company.

### Describing what qualifications and assumptions were made and linkage to principal risks

The sections covering business model, strategy, principal risks and the viability statement should align. More meaningful disclosures are also needed to understand how the underlying analysis was performed and what judgments the company made in arriving at its viability statement.

### Explaining how the underlying analysis was performed

The report encourages companies to share more detail on their modelling approach, including:

- If they modelled individual sensitivities, scenarios and/or a cluster of sensitivities/scenarios;
- How they quantified one-off catastrophic events (if at all); and
- How mitigations were modelled.

The FRC also acknowledges the role that investors have, and suggest they engage with companies to discuss what improvements they wish to see in order to stem any criticism of 'boilerplate' reporting.

## What time horizons are investors interested in?

Due to the variety of investor participants in this project, there are a number of views expressed about the period over which investment decisions are considered. Investors are not necessarily looking for a viability statement which covers the period over which they assess their investment. Rather, they are looking for information which is consistent with other time horizons in the annual report, e.g. strategic and business cycles, debt repayments, lease periods, goodwill impairment, capital investment periods and technology development periods.

*The length of the period should be determined, taking account of a number of factors, including without limitation: the board's stewardship responsibilities; previous statements they have made, especially in raising capital; the nature of the business and its stage of development; and its investment and planning periods.*

Source: **Guidance on Risk Management, Internal Control and Related Financial and Business Reporting**

Investors understand that the directors must have a reasonable expectation which covers the period over which they state viability. They do not expect companies to give unrealistic expectations of the distant future. Companies often select a period consistent with their medium-term strategic plan. However, investors would like to see directors assessing the wider risks and prospects of the company over a longer term. They are looking for disclosure which gives them confidence that the board is addressing long-term threats to the company's business model and is making strategic decisions which maintain the relevance of the company in the long-term.

*31% of reports in our sample show an apparent disconnect between the time period chosen in the viability statement and other parts of the annual report (e.g. the strategic timeline or investment cycle or lifecycle of key resources) but only 7% acknowledge and explain this disconnect.*

Source: **Business Reporting Annual reporting in 2016/17: Broad perspective, clear focus<sup>4</sup>, EY**

The requirements of the Code also allow companies to put in appropriate qualifications and assumptions when making their viability statement.

*Reasonable expectation does not mean certainty. It does mean that the assessment can be justified. The longer the period considered, the more the degree of certainty can be expected to reduce.*

Source: **Guidance on Risk Management, Internal Control and Related Financial and Business Reporting**

## What impact has viability reporting had on companies?

On behalf of the FRC, McKinsey & Company interviewed a sample of FTSE 350 companies on their approach to the viability statement – see 'Risky business: UK plc assesses its viability'<sup>5</sup> overleaf for a summary of these results.

Some companies participating in this Lab project are very positive about the impact that the viability statement has had on their internal processes and specifically how risk is better incorporated into strategic and planning processes.

Other companies say that the introduction of the viability statement has introduced an extra layer of reporting and question the value that this is giving to investors.

Several financial services companies commented that the regulatory context and procedures to which they are subject should provide some reassurance to investors, and they have sought in their viability statement to make the link back to those (e.g. ICAAP).

What is clear is that the companies the Lab spoke to are doing a lot of work in order to assess and respond to the impact of principal risks and support their viability statement.

While companies have always had to assess their liquidity risks in order to apply the going concern basis of accounting, the requirement to make a viability statement (as well as the confirmation of the robust assessment of principal risks) has increased focus on the work that companies do around liquidity and solvency risks. In some cases, it has improved the way in which the company integrates risk into its strategic decision-making process.

<sup>4</sup> <http://www.ey.com/uk/en/issues/governance-and-reporting/corporate-governance/ey-annual-reporting-in-2016-17-broad-perspective-clear-focus>

<sup>5</sup> <http://www.mckinsey.com/global-themes/europe/risky-business-uk-plc-assesses-its-viability>

### Risky business: UK plc assesses its viability

On behalf of the FRC, McKinsey & Company interviewed CFOs, company secretaries and controllers of 17 FTSE 350 companies on their approach to the viability statement and reported on their findings in December 2016. Their results highlight a clear difference between the assessment process in financial and non-financial institutions:

- Financial institutions (six of the 17 companies interviewed) reported that they were generally well equipped to model risk and the incremental work for the viability statement was minimal due to the fact that they are able to rely on regulatory risk processes and modelling frameworks as the basis. The benefit of the work for some was better integrated board discussion on the different strands of risk modelling.
- Non-financial institutions (11 of the 17 companies interviewed) reported less sophisticated processes, although the majority acknowledged that the viability statement process had been useful in improving internal risk dialogue, understanding the quantification of risk, and thinking through mitigating activities.

Regardless of the type of company being interviewed, McKinsey & Company found that the disclosure in the annual report often did not do justice to the underlying exercise.

Overall, the report identified three elements of an 'advanced practice' approach to the viability statement:

- Model stress scenarios (instead of sensitivities), one-off events and mitigations.
- Establish a governance process through both the executive team and the board (and committees), including regular feedback loops into the strategic planning and capital allocation processes.
- Ensure a comprehensive disclosure in the annual report of a company's risk identification framework, rationale for time period considered, modelling approach and governance process.

The report concluded that companies using this approach would not only go some way towards fulfilling the spirit of the Code, but would also be in a better position to take a more integrated view of strategy, risk and return.

Some companies include disclosures in their annual report which describe the work performed by the directors around the viability statement. Investors highlight this type of disclosure as helpful in providing context for the disclosure and understanding the extent of oversight from the board on the assessment process and annual report disclosure.

Investors would like the board to explain how it looks beyond three to five years to demonstrate their stewardship responsibility and show that it is thinking about the company's future beyond the tenure of the current executive management.

*"What has concerned us about the viability statement is this dependency on a single management team and not looking further than that. We have seen that to be detrimental to so many companies."*

Investor

*"I know of no company who is in business right now who is operating on a going concern basis that doesn't believe they are not going to be viable in 3, 5, 10 or 30 years' time. They may know that somewhere along that track they're going to have to change their business, but they don't know when."*

Investor

*"I was against the viability statement when it came in. But it has changed practices in a very good way. There wasn't a systemic framework everywhere in the world. But now, it is more of a coherent approach, and the board can look at it in a coherent way."*

Company

**Example: Vodafone Group Annual Report 2017**

**Long-term viability statement**

As part of the Committee's responsibility to provide advice to the Board on the form and basis underlying the long-term viability statement as set out on page 34, the Committee reviewed the process and assessment of the Group's prospects made by management, including:

- the review period and alignment with the Group's internal long-term forecasts;
- the assessment of the capacity of the Group to remain viable after consideration of future cash flows, expected debt service requirements, undrawn facilities and access to capital markets;
- the modelling of the financial impact of certain of the Group's principal risks materialising using severe but plausible scenarios; and
- ensuring clear and enhanced disclosures in the Annual Report as to why the assessment period selected was appropriate to the Group, what qualifications and assumptions were made and how the underlying analysis was performed, consistent with recent FRC pronouncements.
- Management also sought independent external advice on best practice to ensure appropriate compliance with the requirements of the 2014 UK Corporate Governance Code.

**External audit**

The Committee has primary responsibility for overseeing the relationship with, and performance of, the external auditor. This includes making the recommendation on the appointment, reappointment and removal of the external auditor, assessing their independence on an ongoing basis, negotiating and approving the statutory audit fee, the scope of the statutory audit and approval of the appointment of the lead audit engagement partner.

**Lab Comment**

Vodafone's Audit and Risk Committee reports on their review of the work conducted by management during the process of writing the viability statement. This disclosure provides investors with clarity around where responsibility lies at the board level and what the directors have considered before approving the disclosure.

**The two-stage process: Assessing prospects and stating viability**

The Code envisages a two-stage approach to the viability statement. The directors should firstly consider and report on the prospects of the company taking into account its current position and principal risks. Secondly, they 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.

While the Code suggests that the time period for the assessment of prospects and the statement should be the same, some companies have taken the opportunity to talk about long-term prospects, and then selected a

shorter time period to make the statement on whether the directors have a reasonable expectation of viability. Most investors are positive about this approach.

When discussing the long-term prospects of a company, investors point to the sustainability of the business model as a key consideration, and expect the directors to be able to discuss its resilience to risk and adaptability to market challenges.

Investors also highlight the various timescales discussed by companies in annual reports, investor presentations and during other meetings, and want to understand how these relate to the assessment of prospects.

*The wording of the Code provision that gives rise to the viability statement also makes a distinction between the assessment of prospects and the ability to make the formal statement – directors assess prospects first and then decide whether they have a 'reasonable expectation' that the company will be able to meet its liabilities as they fall due over the period of the assessment.*

Source: Tackling the viability statement<sup>6</sup>, PwC

*"Having to make a choice of a period is quite binary, when actually you need to think about a lot of information."*

Company



6 <https://www.pwc.co.uk/assets/pdf/tackling-the-viability-statement.pdf>

**Example: Equiniti Group plc Annual Report 2016**

Equiniti conducts a significant portion of its business through recurring revenue secured via long term contracts and has a stated modest growth strategy, evidenced both by its past performance and resilience and the position it occupies in the market. A period of three years has been chosen as this period is covered by our financial planning time frame and the Directors have a reasonable confidence over this time horizon.

The Group's strategy is well documented (see pages 16-17). As such, the key factors affecting the Group's prospects are:

- Underlying mix and quality of our client base: we serve 70% of the companies in the FTSE 100, and our revenues are distributed as follows: c46% derived from our top 25 private clients, c36% from other private clients and c18% from our public sector clients. As such, we have a resilient underlying portfolio of clients. We normally provide multiple services under many contracts to each client which diversifies our risk further.
- Market position: the Group is the leading provider of share registration and corporate action services, and the number two provider by the number of pension scheme members. The underlying tenure of FTSE 100 clients for share registration extends beyond 20 years.
- Platforms and technology: the Group has invested continuously in developing and acquiring platform technology that is both proprietary and well recognised in the industry and by its clients.
- Modest but realistic growth aspirations: the Group is targeting organic revenue growth supplemented by acquisitions, with moderate margin improvements driven by offshoring, automation and property rationalisation.

**2. THE ASSESSMENT PROCESS AND KEY ASSUMPTIONS**

The Group's prospects are assessed primarily through its strategic and financial planning process. This includes a detailed annual review of the ongoing plan, led by the Group Chief Executive and CFO in conjunction with divisional and functional management teams. The Board participates fully in the annual process by means of an extended Board meeting.

The output of the annual review process is a set of objectives, detailed financial forecasts and a clear explanation of the key assumptions and risks to be considered when agreeing the plan. The latest updates to the plan were finalised in December 2016. This considered the Group's current position and its prospects over the forthcoming years, and reaffirmed the Group's stated strategy.

Detailed financial forecasts are prepared, with the first year of the financial forecast forming the Group's operating budget and is subject to a rolling forecast process throughout the year. Subsequent years of the forecasts are extrapolated from the first year, based on the overall content of the strategic plan. Progress against financial budgets and key objectives are reviewed in detail on a monthly basis by both the Group's executive team and the Board. Mitigating actions are taken whether identified through actual trading performance or the rolling forecast process.

The key assumptions within the Group's financial forecasts include:

- Organic revenue growth supplemented by acquisitions, supported by market trends and increased cross-selling into our customer base.
- Modest margin improvement driven by operating leverage, offshoring, automation and property rationalisation.
- No change in the stated dividend policy.
- No change in capital structure given the Group has secured term debt and a revolving credit facility out to October 2020.

**3. ASSESSMENT OF VIABILITY**

Although the output of the Group's strategic and financial planning process reflects the Directors' best estimate of the future prospects of the business, the Group has also assessed the financial impact of a number of alternative scenarios.

These represent stresses which include the following potential scenarios:

- Depressed market activity leading to a prolonged reduction in corporate action revenue.
- Reduction in revenue growth for a long period of time, with a lag in cost reduction action.
- Significant change programmes (offshoring/automation/property rationalisation) do not deliver anticipated benefits.
- 20% reduction in planned EBITDA across a three year period.

The results of the stress testing, including a combination of the individual scenarios, demonstrated that due to the Group's high cash generation and access to additional funds that it would be able to withstand the impact in each case. Mitigations considered as part of this stress testing included cost reduction programmes, dividend cuts and a reduction in capital expenditure.

**4. VIABILITY STATEMENT**

Based on the results of the analysis, 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 three year period of their assessment.

**Lab Comment**

Equiniti provides specific information considered key to understanding the prospects of the company:-

- mix and quality of clients;
- market position;
- platforms and technology; and
- growth aspirations.

This gives investors guidance on key aspects of the business. The disclosure is laid out so as to provide context to the assessment process and the key assumptions used.

The disclosure also clearly differentiates between the assessment of prospects and the assessment of viability (which enables the directors to make the viability statement).



## Stress and sensitivity analysis

Stress and sensitivity analysis has been carried out in the Financial Services sector for a number of years. The introduction of the viability statement has led more companies outside of this sector to carry out this analysis, and they have found that it has been useful in shaping internal discussions around risk.

Likewise, most investors highlight that disclosures around stress and sensitivity analysis are useful although current practice is often too high level. Investors are particularly positive about disclosures that provide specific insight into the scenarios considered, including how they link back to the principal risk disclosure. Investors also highlight as useful a description of the outcome of the scenario analysis, including the likelihood and extent of mitigating activities modelled in response to the scenarios.

*"I think it is useful, as it makes us think 'what if...?' It makes you understand the business and forces you to really think about 'what could go wrong'? I do wonder how much of this was being done in the past."*

Company

*"It is difficult to predict, and there are some scenarios where you could go bust overnight. Look at Lehman Brothers."*

Company

*"Would all these scenarios happen at the same time? The point is that we'd never thought of that."*

Company

### Example: J Sainsbury plc Annual Report and Financial Statements 2017

Scenario modelled	Link to principal risks and uncertainties
<p><b>Scenario 1</b> <b>Forecast savings targets are not achieved</b></p> <p>The Group Corporate Plan currently assumes £160 million of synergies as a result of the HRG acquisition in the third full-year post acquisition, along with £500 million of cost savings to offset inflationary pressures by the end of 2017/18. A scenario has therefore been modelled in which all planned savings/synergies are not realised in the years planned and are delayed by one year during the assessment period.</p>	<p>— Business strategy and change</p>
<p><b>Scenario 2</b> <b>Data breaches</b></p> <p>The impact of any regulatory fines has been considered. The biggest of these is the General Data Protection Regulation (GDPR) fine for data breaches, which will be enacted in May 2018. This was considered both in isolation and in conjunction with a fall in sales volumes as a result of any reputational brand damage.</p>	<p>— Data security</p>
<p><b>Scenario 3</b> <b>Legal breaches</b></p> <p>Similar to the above, we considered the reputational impact of any legal or health and safety incidents, modelling a fall in sales volumes in the year of occurrence. We also considered regulatory fines such as those levied by the Groceries Supply Code of Practice (GSCOP).</p>	<p>— Health and safety, people and product — Political and regulatory environment</p>
<p><b>Scenario 4</b> <b>Brexit</b></p> <p>The impact of the UK's decision to leave the EU was considered. Scenarios were modelled assessing potential impacts of weakening sterling foreign exchange rates in all years, as well as World Trade Organisation (WTO) tariffs being applied to inventory purchases in year three of the assessment period.</p>	<p>— Political and regulatory environment — Trading environment and competitive landscape</p>
<p><b>Scenario 5</b> <b>Bank transition</b></p> <p>It was considered what level of sustained loss would be required in Sainsbury's Bank before its capital ratios were breached, leading to additional material funding requirements from the Group.</p>	<p>— Financial and treasury risk</p>

The results of the above stress testing showed that the Group would be able to withstand the impact of these scenarios occurring over the assessment period.

In performing the above analysis, the Directors have made certain assumptions around the availability of future funding options, including the ability to raise future finance.

The scenarios above are hypothetical and severe for the purpose of creating outcomes that have the ability to threaten the viability of the Group; however, multiple control measures are in place to prevent and mitigate any such occurrences from taking place. In the case of these scenarios arising, various options are available to the Group in order to maintain liquidity so as to continue in operation. These include reducing any non-essential capital expenditure and operating expenditure on projects, as well as not paying dividends.

### Lab Comment

The scenario testing disclosure by Sainsbury provides investors with detail around the actual scenarios tested, quantifying certain parts of the test.

The disclosure is clear on the outcome of the analysis, and also links the scenarios to the principal risks and uncertainties disclosed.



## Participants and process

Project participants join Lab projects by responding to a public call or being approached by the Lab. An iterative approach is taken with additional participants sought during the project to obtain input from various types of investors and analysts, and ensure a range of company examples and input.

It is not intended that participants represent a statistical sample. However, a range of companies participated (from AIM through to FTSE 100) and views were received from a range of UK and international institutional investors, analysts and retail investors.

References made in this report to views of ‘companies’ and ‘investors’ refer to the individuals from companies and investment community organisations that participated in this project. Views do not necessarily represent those of the participants’ companies or organisations. The term ‘investors’ includes a broad range of individuals in their capacity as investors or their role in analyst organisations that work in the interest of investors in the UK and overseas markets.

## Involvement of companies

The following companies volunteered to participate in the project:

- Aberdeen Asset Management PLC
- Ashmore Group plc
- AstraZeneca plc
- Croda International plc
- Daily Mail & General Trust plc
- Deltex Medical Group plc
- Dialog Semiconductor Plc

- Equiniti Group plc
- Hill & Smith Holdings PLC
- Intercontinental Hotels Group plc
- Intu properties plc
- ITV plc
- J Sainsbury plc
- Lonmin plc
- M.P. Evans Group PLC
- M&C Saatchi PLC
- Rolls-Royce Holdings plc
- Smith & Nephew plc
- Standard Chartered PLC
- UBM plc
- Vodafone Group Plc

## Involvement of investors

The following members of the investment community participated in the project:

- Aberdeen Standard Investments
- Allianz Global Investors GmbH
- FIL Investment Management Ltd
- Fitch Ratings
- HSBC Global Asset Management
- Invesco Asset Management Ltd
- Legal & General Investment Management Ltd
- M&G Investments
- Moody’s Investors Service Ltd
- Primavenue Advisory Services Ltd
- Schroder Investment Management Limited
- ShareSoc (UK Individual Shareholders Society)
- S&P Global Ratings
- UK Shareholders’ Association
- Walter Scott & Partners Ltd
- 191 individual retail shareholders

## Project process

A combination of individual company meetings and round-table meetings were held with company participants to understand their process and challenges in presenting principal risk and viability disclosures, and share their experiences.

The Lab prepared a discussion pack, which was shared with investors in advance of each meeting, containing reporting excerpts and the project questionnaire. We met each investor to understand their views on current practice, how they use principal risk and viability disclosures, and the information they are looking for in those disclosures.

In addition, two round table meetings were held with investors and company participants together, to further explore views and practical solutions.

A qualitative online survey was developed to obtain retail investor views. In total, 191 respondents completed the survey.

Survey results were combined with interview results to reflect investor views in this report. The report distinguishes results when retail shareholder views and views of institutional investors and analysts differ.

The reporting suggestions provided in this report should be considered by companies in the context of their own circumstances and audience for reporting. The examples used illustrate reporting practices that are considered helpful by investors. The report does not seek to comment on the underlying risks or viability of those companies who are referred to.

## Appendix A: Schroders' letter to FTSE 100 investee companies

In December 2016, Schroders sent a letter to FTSE 100 investee companies concerning viability statement disclosures. The letter is reproduced here.

12th December 2016

Dear XYX

Both the Financial Reporting Council and the Investment Association have in recent weeks put out comment on the current state of viability statements. In the FRC's view only 15% of companies they surveyed across the FTSE 350 had a comprehensive statement.

As equity holders we are providing permanent capital to companies and we are naturally interested in a company's long term viability. We think viability statements, and the process of constructing them, are an excellent opportunity for boards to sense check that the strategic and financial decisions being taken are the right long term ones.

In the FRC's sample, 75% of companies chose a three year time horizon. A survey done by KPMG confirms this, with over half of companies saying it is based on existing budgeting processes. It also coincides with our more informal polling.

It is essential for viability statements that boards consider how companies will perform through an entire business cycle. We note that no company has gone beyond five years, yet it is often the longest running business cycles that can end with the most dramatic changes in the environment. Particular attention should be paid to gearing levels, loan covenants and off balance sheet liabilities to ensure that the balance sheet is robust. We realise that it is difficult to be definitive about the future but it is helpful when companies provide colour to the scenarios, processes and possible mitigating actions that are inputs into their discussions.

Choosing a three year horizon also means that the viability statement rarely covers a period beyond the existing management team's horizon. The average tenure of CEOs in the FTSE is five years, and shortening. As long term investors, we would encourage boards to look beyond the tenure of one management team. In particular, we are dismayed all too often to see dividends cut, exceptionals rise as well as to hear of historic underinvestment when new management come in.

We hope that you will take the opportunity of reviewing your viability reporting as you prepare your next set of Report and Accounts. We have found the viability statement produced by Fresnillo in their 2015 accounts insightful. Interestingly viability is also examined in their Strategic and Risk report and there is a good linkage between these three sections. There is helpful detail provided on a number of scenarios, stress tests and mitigating actions.

Please do contact us if you have any additional questions.

Yours sincerely,

**Global Head of Stewardship**

## Appendix B: Results from survey of retail investors

The Lab undertook a survey of 191 retail investors from ShareSoc and the UK Shareholders' Association. Overall, the results were consistent with the messages heard from institutional investors.

Highlights from the survey are shown here.

- 59% of retail investors think that the annual report and accounts is important for providing principal risk information.
- 57% of retail investors say that their investment decisions are influenced by the robust risk assessment process in the annual report and accounts.
- 62% of retail investors say that their investment decisions are influenced by the principal risk disclosures in the annual report and accounts.
- Retail investors' most popular source of information to identify risks to companies is financial analysis and media, for example analysts' reports and financial/business publications (including business sections of national newspapers).
- For principal risk disclosures in the annual report:
  - The most useful piece of information is the changes in the principal risks since the previous year.
  - Retail investors also find categorisation of risks useful, although had no preference between type or timeframe.
  - There is no obvious preference for risks being presented as either gross or net.
- 61% of retail investors find useful the quantification of the impact of each principal risk. The vast majority would like to see the quantification of monetary impact and likelihood. Some retail investors also suggested quantification of the impact on stakeholders.
- The long-term viability of a company is important to 87% of investors when making their investment decisions.
- However, only 43% of retail investors are aware of the viability statement requirement in the Code. Of those that are aware, over half consider the viability statement useful.
- The most important information to include in the viability statement is:
  - Length of period over which the company has assessed viability.
  - The assumptions and qualifications included in the assessment.
  - The sensitivity/scenario analysis conducted by the company.
- Retail investors on average think that a four year time frame for viability is right. However, individual views ranged from 1 to 10 years, with several citing that it is dependent on the sector and business cycle.
- Almost all retail investors think that disclosure of principal risks and uncertainties and long-term viability could be improved.

# Lab project reports

The Lab's project reports provide practical suggestions on reporting from our work with the corporate and investment communities.

Each of the following reports suggests reporting that is focused on meeting the needs of the investment community for consideration by companies. These reports can be found at:

<https://www.frc.org.uk/investors/financial-reporting-lab/publications>

## Strategic report:

- Towards clear & concise reporting
- Disclosure of dividends – policy and practice
- Business model reporting

## Remuneration report:

- A single figure for remuneration
- Reporting of pay and performance

## Governance reporting:

- Reporting of Audit Committees
- WM Morrison Supermarkets PLC – Disclosure of supplier relationships

## Technology:

- Digital present
- Digital future: A framework for future digital reporting

## Financial statements:

- Net debt reconciliations
- Operating and investing cash flows
- Debt terms and maturity tables
- Accounting policies and integration of related financial information
- William Hill: Accounting policies
- HSBC: Presentation of market risk disclosures

**Information about the Lab can be found at:**

<https://www.frc.org.uk/Lab>

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