Restoring trust through the Resilience Statement

A PwC point of view

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The BEIS '*Restoring trust in audit and corporate governance'* consultation ("the Restoring trust consultation") and the extensive series of reviews and reports that led up to it have been described as a once in a generation chance to reform the reporting, audit and governance system in the UK. So it's important that the process as a whole results in effective outcomes that, as far as possible, fix the problems that gave rise to the consultation, while also making a genuine contribution to building trust.

We now have the Government's (BEIS) response to the consultation and they intend to introduce a statutory requirement for a Resilience Statement for Public Interest Entities (PIEs) with 750 or more employees and £750m or more annual turnover. The Resilience Statement is intended to address the issues with the viability statement and (by association) going concern reporting, which were identified in the reviews by Sir John Kingman and Sir Donald Brydon. A summary of these issues is set out in section B below.

This paper summarises our view of the challenges that the Resilience Statement would need to overcome to be successful and how those challenges might be addressed. It includes an extract from an illustrative example that we've developed showing one possible approach to the Resilience Statement. We have also prepared a more extensive paper, which includes the full illustrative example, showing how changes in the business can affect resilience over time and which provides more explanation about our thought process and approach. This paper is available here.

We would be delighted to discuss our ideas further with any interested party - please see the contact details below.

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A – The Resilience Statement

The annual Resilience Statement will set out a company's approach to managing risk and developing resilience. It will incorporate companies' existing going concern disclosures and build on existing viability disclosures. It will require companies to report on matters they consider a material challenge to resilience over the short and medium term, together with an explanation about how they have arrived at this judgement of materiality. In doing so, companies will be required to have regard to a set of risks (as opposed to being required to address each risk, as was proposed in the consultation), including, for example, any materially significant financial liabilities or expected refinancing needs, significant accounting judgements or estimates that are material to the future solvency of the company, the sustainability of the company's dividend policy, and the impact on the company's business model of climate change. There will not be a minimum five year mandatory assessment period for the combined short and medium term sections of the Resilience Statement, as was originally proposed. Instead, companies will be obliged to choose and explain the length of the assessment period for the medium term section and describe how resilience planning over that period aligns with the company's strategy and business investment cycle. Our interpretation of the Government's response is that there will still be a requirement to set out what the directors consider to be the main long term challenges to the company and its business model.

Companies will be required to provide a minimum of one reverse stress test and disclose material uncertainties to going concern that existed prior to taking mitigating actions or the use of significant judgement, which the directors consider are necessary for shareholders and other users of the Resilience Statement to understand the current position and prospects of the business.

B – What are the problems the Resilience Statement is intended to fix?

We have summarised below our main concerns with current viability and going concern reporting, most of which we believe are widely shared by investors, regulators and even by those who are tasked with preparing it. They are certainly very consistent with the FRC's findings in its recent *Viability and going concern*[1] thematic review. We have also outlined where the BEIS proposals for the Resilience Statement are most directly relevant to these concerns.

1) The period covered

One of the most frequently cited issues with viability statements is that the period covered is not long enough, and that it is often shorter than other time horizons that are demonstrably important to the business, or that are used in impairment reviews or other areas of accounting that are based on forecasted cash flows.

BEIS tackles these criticisms in two ways: i) by proposing that companies explain their rationale for the period selected and how it aligns with the company's business model and strategy; and ii) through the new long-term section of the statement.

2) The connection between viability and risk reporting

Many viability statements claim that all of the principal risks and uncertainties have been considered as part of the viability assessment process, but offer little or no explanation of how this has been done. Many statements also contain stress or scenario tests based on parameters that are not explicitly connected to the principal risks.

BEIS proposes that companies should have to have regard to a number of specific areas of risk in the Resilience Statement, including the risks from major disruptive events, cyber security, and climate change. In this way, they believe that the most common risks relevant to a company's resilience will automatically be addressed. The expectation would presumably be that other principal risks are addressed where applicable.

[1] https://www.frc.org.uk/getattachment/2b213ba8-b950-49e4-838d-d919cbcbd6e6/Going-Concern-and-Viability-Review.pdf

3) The connection between viability and going concern reporting

Viability and going concern statements are mostly made in different parts of the annual report and often also address different issues, with the going concern statement focused on liquidity and the availability of funding and the viability statement on stress and scenario testing of the strategic or business plan. Even where similar issues are addressed, connections are rarely made and there can also be inconsistency between the two disclosures. As an extreme example, we have seen instances of viability statements that fail to mention a material uncertainty for going concern.

BEIS tackles this primarily through the Resilience Statement being a single statement which should encourage more connections to be made.

4) Clarity on the detail of the assessment process and its outcomes

Only a small minority of existing viability statements include quantified information, or even detailed qualitative information, on the parameters used in stress or scenario analysis. This was even more true for going concern reporting until the COVID-19 situation.

Even where stress tests are described in some detail there is usually little or no clarity on the key assumptions that have gone into the underlying business plan, making it difficult to know how challenging the stress testing actually was. And, following on from this, most viability statements simply end with a generic formal conclusion rather than providing information on what the assessment process showed (not surprising when the testing parameters themselves are not clear).

BEIS intends that companies should describe at least one reverse stress test in the Resilience Statement to give more insight into the stress testing exercise undertaken - there is clearly a belief that reverse stress testing (that is, testing that works back from one or more impacts or sets of impacts that would result in the business being unable to continue) is likely to produce information that is particularly useful to understanding a company's resilience.

BEIS also calls for disclosure of close-calls, where a matter is only judged not to be a material uncertainty for going concern "after the use of significant judgement and/or the introduction of mitigating action". Companies often include little or no information on such situations currently: if there isn't a material uncertainty the quality of the reporting generally falls away.

C – What do we suggest in our illustrative example?

We have included below an extract from our illustrative example of a Resilience Statement, where we reflect the BEIS proposals and further evolve them, resulting in a statement that is significantly more different from current viability and going concern reporting than the BEIS proposals would result in by themselves. The full illustrative example can be found here. It is based on a fictional food manufacturing company and, while we have attempted to reflect the possible scenarios facing a company in that industry, it is for illustrative purposes only, so the focus should be on the form rather than rather than the specific details of the scenario.

The key elements of our illustrative example Resilience Statement are as follows:

- Strategic context
- Related risks and priorities
- Management actions
- Board actions
- Board view - impact on resilience

Two beliefs underpin our thinking:

1. That the quality of risk reporting needs to improve considerably if disclosures about resilience are to have real information value; and
2. That there needs to be a unified approach to explaining a company's resilience.

To reflect this, in our illustrative example the company's resilience is analysed by describing in detail the risks that are judged most relevant to its strategic priorities and ambitions, and how management and the board have considered them. The statement is therefore structured around the strategic priorities and risks, rather than by different time periods – the description of each risk includes commentary on the relevant time frames but these are only one factor in explaining the relevant risk and how it is managed. In reality, a single risk is likely to be relevant across a number of different time frames.

Our illustrative example also addresses the effect of long-term aspects of risk on resilience, and includes a number that are relevant beyond the period of most current viability statements.

Most importantly, in our approach the board explains its view of the company's position and prospects, drawing together all the strands of the disclosure. It is this explanation that differentiates the illustrative example statement from the bulk of viability and going concern reporting today[2].

Note that the three time periods used in the formal confirmation section of our example are based on the time frames suggested in the original consultation.

The extract from our illustrative example below shows one year of the Resilience Statement and focuses on just one of the factors that the board of ABC Food Manufacturers identified as being relevant to its resilience: Building scale and margins. As this is a brief document, in some places only the start of the relevant content is included, with a more complete picture, plus explanations and commentary, included with the full illustrative example. In the full illustrative example, we've also shown how it would evolve over three successive annual reports as circumstances change from a matter being disclosed as a principal risk but not an issue for going concern through to a material uncertainty in a way that allows the directors to set the developments in the broader and longer-term context. One of the challenges with going concern reporting in particular is the perception that to be open and transparent about a challenge is a self-fulfilling prophecy: for example if a company reports that there is an issue that could lead to suppliers withdrawing credit terms, then they will do just that. We believe that being open and transparent over time is often the best form of risk management in such cases. The trust and confidence in a company and its board that is built up by meaningful reporting before an issue develops can pay dividends when support is needed to work through a problem[3].

D – How would these new disclosures fit with the rest of the annual report?

The Government recognises that, in the interest of integrated and holistic reporting on risk and resilience, the existing Strategic Report requirement on companies to describe the principal risks and uncertainties facing them should be incorporated within the Resilience Statement. The Government intends that companies within scope be given the flexibility to report these risks within the short- and/or medium-term sections of the Resilience Statement, noting that different kinds of risk or uncertainty may crystallise or resolve over different time periods.

E – How does this fix the existing problems?

We think that reporting in this way will allow companies to address the existing problems by:

- Creating a meaningful discussion of risks facing a company, recognising the nature of each of the relevant risks;
- Breaking down the boundaries between viability and risk and between viability and going concern, all of which become part of a single coherent analysis; and
- Providing real information value to investors and other stakeholders on the company's position and prospects, with detailed information that is placed in its proper context over time.

Equally importantly, our proposed approach can only really be implemented in a case-by-case, company-specific way that gives boards the responsibility to report on the judgements they have made. We understand that there needs to be some degree of comparability between companies' disclosures, but the new statement must also be more than a new set of mandatory boxes to tick if it's to achieve the buy-in that will be needed from preparers and directors, and to lead to a real step-change in reporting.

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[2] Where we see reporting that approaches most closely the quality we are calling for is when a material uncertainty for going concern is being described. In our view this quality should be the aim in a much wider range of circumstances.

[3] Banks should continue to have regard to the FRC's *Guidance for Directors of Banks on Solvency and Liquidity Risk Management and the Going Concern Basis of Accounting*, which may lead to a different approach in certain circumstances to protect the financial system and the economy.

Extract from our illustrative example - Resilience Statement of ABC Food Manufacturers for the year ended 31 December 2020[4]

Resilience Statement

Analysis of factors relevant to the company's resilience

Factor 1 – Building scale and margins

Strategic context

A key strategic goal for the business is to move to tier 1 supplier status with a number of our key supermarket and wholesale customers. This should mean increased negotiating power and an opportunity to improve trading margins. We are targeting this through organic growth in business units [X] and [Y], but M&A activity is also a priority. We expect it to take three to five years from now to achieve this status with most of the relevant customers.

Related risks and priorities

Achievement of synergies
The business is subject to new debt covenants as a result of the debt funding associated with the major acquisition in the year. In order for the expanded group to stay within the covenant ratios, it is important for us to achieve the synergies we have targeted in good time, and also to develop the combined businesses according to plan.

Wider development of the business
We also need to build the wider business through organic growth and leveraging our additional scale. This forms part of the overall business plan for the next five years shared with the lending syndicate, including specific targets for market share and trading margins.

Availability of suitable M&A targets
We have developed a pipeline of possible projects over the next three years, though there is always a risk that others will move first, given the importance of scale to the industry.

Availability of finance
As we implement our strategy it is possible that amendments to the plan caused by new opportunities or delays could result in a need to raise additional finance. Some of our facilities will also come up for renewal during the period of the current strategy, starting with the [A] Notes in year four (2024).

Business interruption
Significant interruptions to the business (such as uninsured major health & safety related events or food safety issues, cyber attacks or matters outside the control of the company like COVID-19) could have an impact on trading performance sufficient to affect covenant compliance.

Management actions

- The overall business plan was developed with advice from [Advisory Firm A], taking into account the results of other M&A activity in the industry.
- Management has carried out stress testing on the delivery of the overall business plan using a number of severe but plausible scenarios.
  - Scenario 1: [a-b]% of the synergies not achieved in year one and [x-y]% in year two, equating to approximately a three month delay overall; organic growth in business unit [x] revenues is zero in year one and [x]% in year two; trading margin is reduced by [x] percentage points due to unplanned increase in ingredient prices; food safety issue causing significant damage to brand [b].
  - Scenario 2 etc...
- Reverse stress testing has been carried out to determine the extent of financial change that would threaten the business, along with an assessment of how this could most realistically happen in practice and the likelihood of this occurring. Two scenarios have been used, one based on a major downturn in the business affecting organic growth and one based on a major operational issue.

[4] This example is for illustrative purposes only and so focus should be on the form of the statement rather than the detailed content. For the purposes of this extract we have only included one factor, however in reality a company would have more. Also, as noted in Section C above, as this is a brief paper, in some places only the start of the relevant content has been included, but can be seen in our more detailed document on the Resilience Statement.

Board activities

- On behalf of the board the audit committee assessed the effectiveness of the risk management systems on which the above analysis was based, and the effectiveness of the controls around budgeting and forecasting and synergy tracking in particular.
- The board as a whole considered the outcome of the scenarios tested in the stress testing and assessed the likelihood of the potential issues used in the reverse stress testing.

Board view – impact on resilience

The company is still in the early stages of its refreshed strategy and of the financing arrangements around the major acquisition in the year, but these developments represent a significant step up in our risk appetite, particularly around the increased leveraging of the balance sheet. The covenants mean that we need to trade in line with our business plan over the next 12 months, so it is important that the business delivers on the forecast synergies without significant lag.

Our view is that the plans in place to deliver on the overall business plan and strategy over the next three to five years are sound (including the risk management and internal control arrangements), and that reasonable contingency plans are also in place in the event that the plan needs to be flexed. The financing arrangements we have taken on to date are manageable and contain no unusual terms or conditions.

The results of the stress testing showed that additional management action would be needed by the second half of 2022 if scenario 1 occurred. The initial actions to address this (which would also be needed to stay within the related covenant tests) would most likely focus on delaying certain marketing activity and rephasing the ongoing programme of improving the energy efficiency of plant & equipment at our older sites. The most challenging reverse stress test was carried out by sensitising several specific parameters such as net revenue, EBITDA and free cash flow individually. This demonstrated that an [x]% fall in net revenue would be the first factor to affect overall solvency. The board noted that this would in effect equate to the loss of two of the top four customers.

Overall, the refreshed strategy is vital to the ongoing sustainability of the business model in that it prepares us to face the generally more medium to long-term challenges that are identified below. It is also vital to our ability to cope successfully with a long period of uncertainty, such as that experienced in connection with the COVID-19 pandemic. Our business is inherently resilient in such circumstances as an important part of the UK food industry.

Formal confirmations

Short-term resilience

Having considered all of the matters set out above, the board believes it is appropriate to prepare the financial statements on the going concern basis.

No material uncertainties were identified and there were no matters that were decided by the board not to be material uncertainties after the use of significant judgement and/or the introduction of specific mitigating action.

Medium-term resilience – five years from 1 January 2021

The directors confirm that on the basis of the above assessment of the company's prospects and resilience, including the results of the short and medium-term stress testing, they have a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due over a period of five years from 1 January 2021.

There were no other matters that the directors judged necessary to report in relation to short or medium term resilience, including in relation to digital security risks (see page [x] for more information) or the sustainability of the company's dividend policy.

Long-term resilience

The matters above, reflect the directors' assessment of the long-term challenges to the company and its business model, and how these are being addressed.