THE
INVESTMENT
ASSOCIATION
INVESTMENT MATTERS

The Investment Association
Guidelines on Viability Statements

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Registered office: The Investment Association
Camomile Court, 23 Camomile
Street, London EC3A 7LL
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INTRODUCTION

These guidelines have been prepared by the Investment Association (IA), the representative body for the UK asset management industry and institutional investors in listed companies. As a company's shareholders, the IA's members are key users of the information in the annual report and accounts. They welcomed the changes the Financial Reporting Council (FRC) made to the UK Corporate Governance Code (the Code) in 2014 to require the directors to disclose their views about their company's risks, long-term health and strategy. Specifically directors are required to prepare a "viability statement" and to:

> *Explain how, taking account of the company's current position and principal risks, they have assessed the prospects of the company, what period the assessment covered and why this period is appropriate.*
>
> *Confirm 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*[1]*.*

These disclosures are valuable to the IA's members. They provide a company with risk capital and want to understand how that company puts that capital to use and its prospects over the long-term. The viability statement and the directors' confirmation that the company will continue in operation and meet its liabilities is particularly important for investors, including bond investors, in ensuring that companies do not abuse their limited liability protection. Moreover, depending where the statements are placed they can be subject to the Companies Act's safe harbour[2].

Whilst a few companies reported under the new provisions early, the majority first adopted them in 2016 in respect of 2015 year ends[3]. To help companies with these disclosures going forward, these guidelines set out the expectations of institutional investors. They have been developed with the benefit of one year's experience and will be reviewed in the light of best practice as it evolves.

The Code applies on a comply or explain basis to companies whose shares are admitted to the Premium segment of the Official List of the UK Listing Authority[4]. These guidelines are directed to these companies. For companies that are not subject to this regime, these guidelines should be considered best practice. The IA's corporate governance research service, IVIS, will continue to monitor companies' viability statements and in so doing will have regard to these guidelines.

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[1] Code Provision C.2.2.

[2] Section 463 of the 2006 Act contains a safe harbour in respect of directors' liability for statements made, either directly or via a cross reference, in the strategic report, the directors' report and the directors' remuneration report. Under the safe harbour, a director will be liable only in relation to statements which he/she knew, or was reckless as to whether they, were untrue or misleading or where there is deliberate and dishonest concealment of material facts. The safe harbour also provides that liability is only to the company and not to any third party.

[3] The 2014 Code applied for accounting periods beginning on or after 1 October 2014.

[4] The FCA removed the Code's comply or explain approach with regard to viability statements when it issued Listing Rule 9.8.6 R (3) (b). It is therefore mandatory for companies whose shares are admitted to the Premium segment of the Official List to make such a statement in their annual report.

1. PERIOD FOR THE VIABILITY ASSESSEMENT

The IA has noted that many discussions around the viability statement have tended to focus on the period of the assessment. The Code leaves it for the directors to decide on the period. The FRC's Guidance on Risk Management, Internal Control and Related Financial and Business Reporting stated that, except in rare circumstances, the period should be significantly longer than 12 months. In this context, it is helpful if directors:

- **Consider longer time horizons.** The flexibility afforded by the Code should allow directors to select the most appropriate period for their business when assessing its future viability. However, the majority have tended to adopt a three year time frame with a few, such as major utilities and property companies, looking longer to five years. Three or five years seems to have become standard practice and is often justified as reflecting the medium-term business plan.

  The IA's members consider there should be more differentiation between companies and that viability statements should address a longer timeframe (than three or five years) given the long-term nature of equity capital and directors' fiduciary duties.

- **State clearly as to the why the period was chosen.** The FRC's Guidance states that in determining the length of the assessment period the factors to be considered include: the board's stewardship responsibilities; previous statements – particularly when raising capital; the nature of the business and its stage of development; and the investment and planning periods.

  It is important to investors that directors are clear as to why they have selected the particular timeframe. Experience to date has shown that frequently the explanation for the assessment period is, as noted above, that it is based on the medium-term business plan. Investors value directors making it apparent how they have considered wider factors, as set out in the FRC's Guidance, in determining the period. In particular, the specifics of the company's business and sector need to be considered, and not only its business cycle but its investment cycle as well.

- **Differentiate time horizons for prospects and viability**. A company may have different plans to cover short, medium and long-term horizons. For example, it may have a long-term strategic plan that looks forward over 20 years, a medium-term business plan that covers five years and a short-term budget for the following year. It is helpful if the disclosures around prospects address the long-term strategic plans and look longer than the period over which viability is assessed.

2. CONSIDER PROSPECTS AND RISKS WHEN ASSESSING VIABILITY

The Code requires directors to take account of the company's current position and principal risks, and assess its prospects as the basis for their viability assessment. Undoubtedly these matters should be closely linked and if done well should give investors valuable insight into the company's strategy, business plans, and any associated risks. Investors consider that directors need to be clear as to how these matters have been addressed. They would be concerned if the requirement to assess viability resulted in the disclosure of principal risks being limited in any way or alternatively discouraged directors from taking appropriate levels of risk as part of their medium/long-term business strategy. In this context, directors should consider the following.

- **Current state of affairs.** Investors consider it important that the directors do not limit consideration of viability to medium or long-term risks but also look at the current state of affairs. At the time the changes to the Code were introduced there were concerns that including the requirement for a viability statement in the Code's section on Risk Management and Internal Control could result in directors limiting the scope of the matters considered to the company's risks. Investors' preference was for the requirement to be included in the Financial and Business Reporting section so that it is clear this is not the case.

- **Sustainability of dividends.** The IA's members as investors in companies provide them with equity or risk capital. The dividends received are an important return on that capital and investors would welcome the viability assessment addressing the sustainability of those dividends.

- **Distinguish risks that impact performance from those that threaten operations**. A company will be exposed to risks that impact its performance and which could prevent it delivering its strategy. Such risks are important in assessing the company's prospects and its future plans. These risks should be distinguished from those that threaten its day to day operations and the company's existence. It is the latter risks that should be considered for the viability assessment.

- **Separate prospects from viability.** Investors want companies to give them an insight into their plans for the future which may be separate from the plans that support the viability statement. To facilitate this directors may wish to consider separating their assessment of prospects from their assessment of viability. The former then gives them the opportunity to demonstrate that they have considered the future of the business over the long-term. This may be particularly relevant for industries with long-term contracts or assets, for example, pension providers and extractive industries.

- **State clearly why the risks are important, and how they are managed and controlled.** The description of principal risks should enable investors to understand why those risks are important to the company, how they are managed and controlled, and how the company would respond if they were to crystallise. They would welcome disclosures that address the likelihood of the risk occurring and its possible impact. It is also helpful if the potential timing, and any significant changes in either the risks and/or their impact are highlighted.

- **Prioritise risks.** As regards the risk disclosures themselves, companies were already required to disclose information on their risks[5]. Other changes to the Code in 2014 required directors to:

  Describe the principal risks and how they are mitigated.

  Confirm that they have performed a robust assessment of the principal risks, including those that would threaten the company's business model, future performance, solvency or liquidity[6].

  The Code's principles based approach gives directors the flexibility to describe the risks in their own words. The changes also gave directors an opportunity to reassess the risk disclosures and consider whether they are coherent and present a meaningful assessment. However, too often the description of risks lacks structure or is presented as a shopping list to cover all bases.

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[5] For example, there are requirements in the Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013 and IFRS 7.

[6] Code Provision C.2.1.

Neither approach reflects clarity of thought. The risks disclosed should be those that are the most pertinent to the business and the company's strategy. The directors should exercise their professional judgment in determining which risks are important and how they should be disclosed. It is also helpful if the risks are ranked (for example, low, medium, high) and whether the risk has increased in likelihood or decreased from the prior year is disclosed. Good risk disclosures give investors insight into the quality of management which sometimes can be as useful as the information itself.

3. STRESS TESTING

When directors assess a company's prospects and viability the IA understands stress tests are likely to be undertaken to see whether the strategy is viable and evaluate any barriers to its execution. Often rather than test the principal risks themselves, particular scenarios will be developed. However, investors are not always made aware of the extent of these and would welcome more transparency as to:

- **The specific scenarios considered and likely outcomes.** Disclosures are often limited to either simply confirming that stress testing has been undertaken or a description of the process. This is a missed opportunity. Investors find it particularly insightful when each of the specific scenarios considered is disclosed, together with the likely outcomes. They can then form a view on the quality of the company's processes for making that assessment and management's thoroughness.

- **Specific mitigating or remedial actions.** Often companies make a general statement that mitigating actions have been taken or remedial actions may be necessary. Investors would appreciate a description of the specific actions taken or which may be necessary. There should be an explanation of what could cause the risks to crystallise, the likely impact and how this could be mitigated or managed. Such disclosures give investors' confidence that the directors have explored the company's resilience to the potential risks over the long-term.

- **Any reverse stress testing**. Reverse stress testing is when scenarios and circumstances that would mean the business model is no longer viable are assessed, together with their plausibility. Whilst required for companies in the financial services sector, investors would welcome companies in other sectors undertaking such tests and disclosing the scenarios considered.

4. QUALIFICATIONS AND ASSUMPTIONS

The Code expects directors to draw attention to any qualifications or assumptions as necessary. Investors consider that these should be:

- **Differentiated.** Investors consider that qualifications should be distinguished from assumptions. Essentially a company will continue to be viable on the assumption an event or condition occurs or exists. On the otherhand a qualification means that the company will not be viable if something occurs or exists. There are more likely to be assumptions than qualifications.

- **Specific to the company.** It is important that any qualifications or assumptions are specific to the company, rather than generic such that they could apply to any company's statements about the future. Nor should they include matters that are highly unlikely to either arise or have a significant impact on the company.

ABOUT THE INVESTMENT ASSOCIATION

The Investment Association is the trade body that represents UK investment managers, whose 200 members collectively manage over £5.5 trillion on behalf of clients. Its purpose is to ensure investment managers are in the best possible position to:

- Build people's resilience to financial adversity.
- Help people achieve their financial aspirations.
- Enable people to maintain a decent standard of living as they grow older.
- Contribute to economic growth through the efficient allocation of capital.

The money its members manage is in a wide variety of investment vehicles including authorised investment funds, pension funds and stocks & shares ISAs.

More information can be viewed on the website.