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Investment company technical release

September 2015

Viability – making a statement

The 2014 UK Corporate Governance Code ('the Code') applies to accounting periods commencing on or after 1 October 2014 and therefore will apply first to 30 September 2015 year ends for investment companies on a normal twelve month reporting cycle. One of the most significant changes arising from this latest update involves the introduction of a new disclosure requirement regarding the directors' assessment of the future prospects of the company - often referred to as the 'viability statement'.

The new viability disclosure is distinct from the statement required by directors in respect of the going concern basis of accounting and boards will need to give careful consideration to the framing of this new disclosure in the forthcoming reporting season.

Viability and going concern

In reporting terms the 2014 Code now makes a distinction between a company's going concern status and its future viability.

An assessment of whether the company is a going concern is an accounting basis assessment and has been around for many years. The 2014 Code continues to require the directors to make an explicit statement in the financial statements regarding whether the going concern basis of accounting has been adopted in the basis of their preparation. The going concern statement will need to identify any material uncertainties to the company's ability to continue to apply the going concern basis over a period of at least 12 months from the date of approval of the financial statements.

The new requirement for a viability statement is additional to this and involves a broader assessment as to the company's future viability, based on a robust assessment of the company's principal risks and its current position;

> *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.*
> **[2014 Code provision C.2.2]**

The underlying premise here is that whilst the use of the going concern basis of accounting may be appropriate having regard to accounting standards, there may still be risks that threaten the company's business model, future performance, solvency or liquidity that should be disclosed to shareholders. Whilst the period covered by the going concern review is at least 12 months from the date of approval of the financial statements, it is expected that the assessment required in respect of the viability statement will cover a significantly longer period. As the viability statement covers a longer period, there may inevitably be more uncertainty surrounding the disclosures given and this uncertainty will need to be explained.

Period of the assessment

Boards are required to disclose the time period over which they have carried out the viability assessment and the reasons why they consider this period to be appropriate.

The Code does not prescribe the period that the viability assessment should cover but clearly it should be specific and relevant to the company. Not all companies will necessarily cover the same length of period but considerations for an investment company may include (inter alia) the company's investment strategy and policy, its investment horizon, any arrangements or commitments for returning capital to (or raising capital from) shareholders, whether the company has a fixed life, the frequency of any continuation votes provided for in the company's articles, and the frequency of its strategic planning cycle.

As noted above, it is expected that the period covered will extend significantly beyond that required by the going concern review. This is confirmed in the FRC's latest Guidance on Risk Management, Internal Control and Related Financial and Business Reporting, which states that 'except in rare circumstances it should be significantly longer than 12 months from the approval of the financial statements'.

It remains to be seen what time horizons companies will choose to apply in practice but our expectation would be that, on balance, the period covered is likely to be of the order of three to five years on average, subject to any company specific circumstances such as (for example) the proposed life of the company or the implementation of investment realisation strategies.

Matters considered when making the assessment

Directors will need to explain how they have assessed the prospects of the company, and this will require an explanation of the matters considered in making that assessment. The FRC's guidance indicates that assessment should be robust and based on 'those risks that would threaten the business model, future performance, solvency or liquidity of the company, including its resilience to the threats to its viability posed by those risks in severe but plausible scenarios'.

Whilst it would be a somewhat exceptional set of circumstances which would give rise to an investment company being unable to meet its liabilities as they fall due, the questions of solvency and liquidity need to be considered hand in hand with the wider question of whether the company can be reasonably expected to continue in operation. Relevant considerations over the assessment period might therefore include not only matters such as expected financing and capital cash flows, income and cost projections, financial KPIs etc but also principal risks (informed perhaps by risk matrix output), strategic plans and market forecasts, investment opportunities, current or upcoming regulatory changes, compliance with key laws and regulations such as investment trust or VCT tax status, factors related to investor demand and share price premium or discount control, company size (and related cost and share liquidity issues). For a number of investment companies the time horizon for the assessment will also inevitably involve considering any forthcoming continuation votes. Boards are already familiar with having to look to the next AGM for the purpose of considering the impact of a continuation vote on the going concern basis, but the time horizon for the viability statement will involve assessing the impact of continuation votes beyond the traditional 12 month period.

So far as the question of resilience to threats posed by 'severe but plausible scenarios' is concerned the FRC's guidance suggests that simulation techniques such as stress testing may help the directors in making their assessment. A form of 'what if' analysis could be applied across a range of possible events or scenarios but may be particularly useful for analysing risks linked with the level or performance of markets. As part of the assessment it would however be appropriate for the directors to take full account of any actions which they could reasonably take to reduce the impact of the risks arising.

Qualifications and assumptions

As the viability assessment will cover a period further into the future than the going concern statement, this will inevitably lead to greater uncertainties attaching to the results. Directors will therefore need to draw attention to risks or assumptions which are likely to be significant to the shareholders' understanding of the viability statement.

FRC have indicated that, as a matter of principle, these qualifications and assumptions should be specific to the company. In other words, they ought not to be so generic that they could apply to any predictions about the future. In the interest of being clear and concise they should also include only those matters significant to the company's prospects and should be relevant to an understanding of the directors' reasons for making the statement. There is no need to disclose qualifications and assumptions if they are highly unlikely to arise or have a significant impact.

For some investment companies, strategic planning may make certain assumptions, for example concerning matters such as the extent of performance of the portfolio, the availability and cost of gearing, shareholder voting in relation to continuation or reorganisation – it is important to emphasise again that the relevant assumptions or qualifications will be company specific.

The directors' statement and its location

In summary then, the directors' statement will include the following disclosures:

- the time period covered by the assessment and why that time period was considered appropriate
- the matters considered when making the assessment
- the degree of certainty that can be attached to the statement
- whether the directors 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.

However, it is important to note that the new statement is clearly related to a number of other disclosures required by the Code and also by statute, in particular those relating to principal risks and uncertainties facing the business including how they are managed or mitigated. As there will be some overlap with these other disclosures, this raises the question of where best to locate it.

Although companies can choose where to place the viability statement, it would not generally be appropriate for it to be placed in the financial statements. Directors may however benefit from the safe harbour provisions of s463 Companies Act 2006 if the disclosure is located in the strategic report or the directors' report. Given the overlap with the risk and uncertainty disclosures mentioned above it may be that it is easier to avoid repetition by including the viability statement in the strategic report, perhaps as part of a risk management section. In our view this would be a logical location and would make any cross-referencing more straightforward. In terms of length, although the relevant considerations involved in making the new viability statement are wide reaching, our expectation would be that it might typically be possible for the disclosures to be capable of being articulated in three or four paragraphs, extending perhaps up to around half a page of the annual report, depending on the company's circumstances.

Contact us

Cyril Swale
T +44 (0)1481 753416
E cyril.swale@gt-ci.com

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