Brydon's proposals for a new Resilience Statement

Let's get this right

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Aims of this paper

In 2019, Sir Donald Brydon published his independent report into the quality and effectiveness of audit. One of the report's key recommendations was the introduction of a new Resilience Statement to provide more information and assurance about the resilience of a company.

The aim of this paper is to explore the details of Brydon's proposals for a new Resilience Statement. It sets out our views on the benefits of a Resilience Statement, such as demonstrating the extent to which a company's business model can withstand risks arising over different time horizons. It also highlights key questions in respect of these recommendations, which need to be resolved to avoid unintended outcomes, particularly around going concern assessments.

In our view, to drive meaningful change, the new Resilience Statement should be subject to separate assurance under a clear framework, Directors should be accountable for providing high-quality disclosures and the regulator must act proactively to challenge companies on resilience reporting.

The audit profession is ready to play its part on this important issue. Maintaining confidence in the capital markets depends on getting this right.

Michelle Hinchliffe
UK Chair of Audit

In summary

- Brydon's proposals are a step in the right direction.
- The current viability and risk disclosures need to be enhanced.
- Linking short-, medium- and long-term assessments into a single disclosure provides more useful information.
- Excluding mitigations from going concern assessments could result in capital inefficiencies, constraining growth if Directors become risk averse.
- A clear framework is needed for users to prepare a Resilience Statement.
- The proposals will encourage companies to demonstrate a clear link between Purpose, Strategy, Risk Management and their Business Model.
- Directors should be accountable for managing resilience and providing high-quality disclosures. Regulators need to be proactive in challenging these statements.
- The external auditor should provide assurance over the medium-term Resilience Statement and, if commissioned, the long-term statement. The scope may vary based on the nature and risk of the company. The audit should continue to assess going concern.
- Assurance over forward looking statements can add value to users and increases the attractiveness of the UK's regulatory environment for investors.

Next steps

- Given the importance of these proposals, there is a clear need to initiate a consultation process as soon as possible. The views of investors, preparers and the audit profession, are key to inform any changes introduced by government or regulators.

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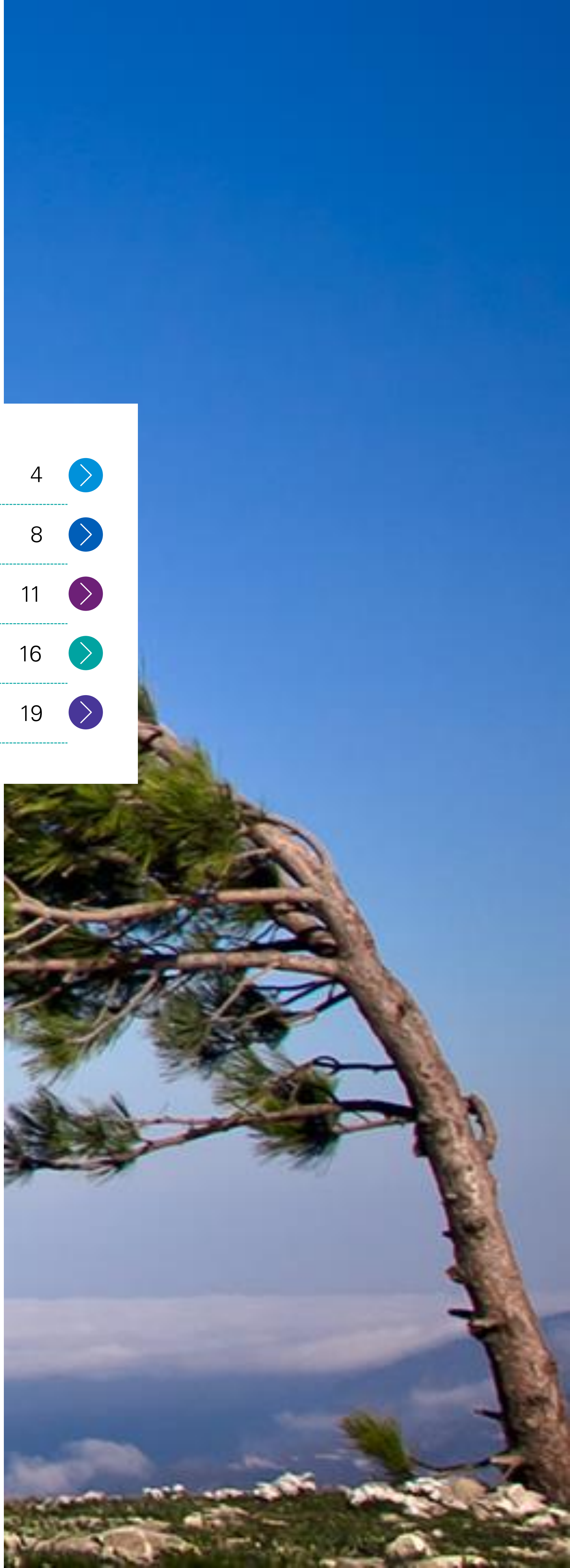

01.

The proposals

Why now

“Arguably, the information shareholders want most is reassurance about the resilience of a company”

Sir Donald Brydon, December 2019

It has never been more important to provide shareholders with better information and assurance about the resilience of a company. Shareholders want to understand the threats to a company's business model over different timescales, and the risk management processes implemented by the Directors to withstand those risks.

Companies need to be resilient to systemic risk. The global economy has been rocked by two huge shocks in only 15 years, most recently with COVID-19. Climate change is a serious long-term threat, while cyber security attacks can cause widespread disruption and reputational damage in a matter of hours. We therefore need to shift from conventional approaches to assess whether companies are resilient in a world where risks are inextricably connected, crystallising over different time horizons.

Modern business models are vulnerable to a range of risks. After its first 35 years of trading, only one in three of the original FTSE100 companies remained in the index. Resilience is therefore critical to maintain long-term returns. The shift in preference to debt financing increases the need to stress test balance sheets. Business models with low margins and high gearing in benign trading conditions may be particularly vulnerable when things change.

These factors have driven an increased demand for more information about a company’s resilience to its principal risks. Corporate failures have further highlighted the need for change, with increased media attention on company distributions. The 2019 report published by Sir Donald Brydon aims to redress this through the introduction of a new Resilience Statement in Company Annual Reports.

We welcome Brydon’s recommendations to enhance reporting on company resilience. In our view, companies need to go beyond the existing disclosures in order to provide more information about their ability to withstand risks arising over different periods of time.

Auditors could also have a more important role by providing an independent view on forward looking statements. We believe the external auditor should provide this assurance given many financial statement balances depend on assumptions about the future performance of a company. These requirements need to be practically implementable, cost effective and aligned to the auditor’s responsibilities.

By challenging the information companies provide on resilience under these recommendations, we can help better inform capital allocation decisions and enhance the attractiveness of the UK’s regulatory environment.

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The proposals

In 2018, the Secretary of State for Business, Energy and Industrial Strategy (BEIS) commissioned Sir Donald Brydon to conduct a review into the quality and effectiveness of audit. The review's objectives aimed to address the perceived widening of the 'expectation gap' between what auditing standards require and what shareholders expect from an audit.

Brydon found a widely held view that accounts, and therefore the audit, are too backward looking. However, Brydon highlights that there are many accounting estimates, such as goodwill valuations, that depend on forward looking assumptions and estimates.

The valuation of a company today depends on where it is headed, and its ability to deal with the risks and opportunities it faces going forward. The basis upon which Directors assess the resilience of a company based on their future assumptions – and move beyond existing requirements.

Recent corporate failures have given even greater emphasis to the need for better disclosure and assurance. The use of hindsight is of no benefit, when a more rigorous assessment and disclosure of the company's ability to withstand specific scenarios could have identified underlying vulnerabilities.

Brydon recommends the implementation of a Resilience Statement to replace the existing requirement for premium listed companies to prepare a Viability Statement. The Viability Statement was introduced in the UK Corporate Governance Code 2014 to drive greater focus on risk management and demonstrate how Boards have assessed the sustainability of a company's business model and strategy in response to those risks.

Brydon highlights that, too often, Viability Statements are criticised as being 'boilerplate'. They fail to meet investor expectations to sufficiently explain how the Board has analysed long-term resilience beyond the three-year time horizon most companies adopt. The level of disclosure given about the scenarios tested also varies.

Importantly, the viability statement is not subject to specific assurance from the external auditor under existing auditing standards, which only require the external auditor to confirm the statement is consistent with the financial statements and their knowledge obtained during the audit, including the going concern assessment.

A Resilience Statement is also intended to address Brydon's concern that the current Going Concern requirements mask material uncertainties by allowing Directors to take mitigating actions into account. Those actions must still be within the Company's control. However, Brydon proposes changing these requirements to prevent the impact of such countermeasures being included. This would lower the threshold at which material uncertainties over going concern need to be disclosed.

Three statements

Brydon recommends that the new Resilience Statement is broken down into three different time periods, as shown below. In Brydon's view, this provides a coherent view of the future and should be linked to the company's principal risks and uncertainties.

1

Short term

- Time horizon of one year, although a longer period may be adopted if appropriate. This is up to two years.
- Includes a statement that, in the opinion of the Directors, the company has the necessary finance to survive for this period.
- Disclosure of any material uncertainties, by reference to the Risk Report, before any relevant mitigating action.
- Audited in the same way as today's going concern statements.
- Forms the basis of preparation for the financial statements.

*The Brydon report does not state if this is one year from the date the financial statements are approved. However, a time period applied from the date the financial statements are approved would be consistent with the current going concern requirements.

2

Medium term

- From the end of the short term statement to five years.
- Includes a statement that the Directors have tested the company's probability of survival in relation to declared future scenarios.
- An assessment of the company's resilience in light of the stress testing performed.
- Option to use those scenarios published by the PRA for stress testing or say which other defined scenarios have been tested.
- Option to obtain independence assurance that the work has been undertaken appropriately. Such assurance would not consider the conclusions which would remain a matter entirely for the directors.
- The extent of this work, including the extent to which independent assurance has been obtained, would be consistent with the Audit and Assurance Policy presented to the shareholders by the Directors. The introduction of an Audit and Assurance Policy is part of Brydon's overall package of reforms.

3

Long term

- Beyond five years, up to an indeterminate period.
- A statement about the long-term resilience of the company made by reference to the sort of threats the company may face, such as climate change.
- Describes either why the Directors believe the company is resilient in the face of such threats or what processes are in place to enable the company to plan its reaction to these threats.
- No requirement for further assurance, although the Directors would be free to outline in their Audit and Assurance Policy any supporting work they had commissioned.

02.

A step in the right direction

A step in the right direction

How do these proposals enhance reporting beyond the current viability statement?

A long-term view

The market capitalisation of many companies is often underpinned by the value attributed to the long-term cash flows expected to be generated beyond three years. An assessment of the company's resilience over the medium and long-term will provide shareholders more visibility into the risks and opportunities, which could impact its value or be an existential threat. Brydon rightly highlights climate change as a good example of an emerging threat over this timescale, which is beyond the current requirements. Other risks and opportunities could include the development of artificial intelligence, 3D printing and the increased commercialisation of space by private companies. We support bringing this long-term disclosure into one place together with the shorter term going concern disclosures.

Focusing on business models

In our view, Brydon's recommendations will shine a light on business models that are not resilient to those risks identified by Directors. Shareholders will gain more understanding of how risks can impact a company and the Board's risk appetite. These proposals will drive further improvements in risk management processes. Boards should challenge management on how the company will respond to risks. This should include high impact and low probability events, or threats which evolve over longer time scales. More severe scenarios and sophisticated techniques may be necessary to satisfy shareholders.

Boards will also need to re-evaluate whether they need to change their funding strategies to provide the desired level of resilience based on the company's risk appetite. Resilience statements help provide an early warning to Directors that they may need to change course or strategy, including in response to long-term threats. This can help avoid economic shocks caused by unexpected corporate failures when risks crystallise.

Stress testing declared scenarios

The emphasis on 'stress testing' encourages Boards to think hard about the impact of those scenarios which could threaten the survival of a company. This provides an opportunity to measure the level of resilience of a company and take appropriate countermeasures. This concept is not new, and the financial services sector introduced similar stress tests after the 2008 recession. Outside financial services, one size is unlikely to fit all, so Directors will need to be clear in explaining their determination of the appropriate scenarios. There is however an opportunity for independent, centrally declared scenarios against which Directors can compare their scenarios. This would be similar to PRA's approach but tailored to specific industries.

The use of reverse stress testing also has a role to play in establishing the point at which a failure could arise and how close the scenarios tested are to that limit. The importance of stress testing is currently emphasised in the FRC's guidance on viability statements, based on severe but plausible scenarios. Brydon's recommendations would additionally require boards to declare the scenarios considered, increasing transparency of the Board's considerations.

Short-term proposals don't work

Medium- and long-term disclosures must build upon a company's going concern assessment. As set out on page 12, the time period and proposal to exclude mitigations from the short-term statement would not enhance resilience reporting and could lead to unintended consequences.

Independent Assurance

We support the need for additional assurance over the Resilience Statement

Providing more independent assurance

Auditors assess whether Boards are sufficiently responsive to those risks which could threaten a company's survival as part of their work over going concern. Brydon encourages further assurance over the medium term statement, for companies with greater complexity, or based on the Directors' view that it is appropriate to do so. Auditors could have an even greater role to play in challenging those medium and long term scenarios and appraising the completeness of the risks identified. Shareholders should challenge Boards on their decisions about obtaining further assurance. The Audit Committee report within the annual report would be the right place to explain those decisions, based on the Company's Audit and Assurance Policy.

Brydon does not specify who should provide this assurance. However, he does highlight that many judgements and estimates in the financials are based on forward looking cash flows. Therefore, decisions which are fundamental to the audit opinion are intrinsically linked with those assumptions in the Resilience Statement. In our view, the external auditor should provide this assurance to shareholders, as discussed in the next section of the paper, including the nature of that assurance.

Linking risk to assurance

Brydon's proposals put the onus on the Directors to decide on the appropriate level of assurance based on the company's published Risk Report. A similar approach has been adopted in other regulatory frameworks, such as utilities, for financial disclosures or returns prepared outside the accounts. Where additional assurance work is carried out, separate assurance reports should provide enough detail for users to understand the procedures performed and key findings.

Bridging the expectation gap

As Directors will be able to choose whether to obtain further assurance, the external audit report should also be clear on the auditors' responsibilities in respect of the Resilience Statement and the limitations of the work performed where no assurance has been obtained. This is important to help bridge the expectation gap and give more clarity on the overall level of assurance provided to shareholders.

Directors should be transparent on the controls and governance in place in preparing the Resilience Statement, which could itself be subject to further assurance. Internal Audit could also have an important role to play in attesting to the effectiveness of those controls. In our view, policy makers should incorporate the controls in place over the preparation of the Resilience Statement to any new attestation on internal controls made by the CEO and CFO.

Setting clear expectations

In our view, audit has an important role to play in providing additional assurance. That may vary based on the nature, risk and scope of the audit. That can range from assurance over the controls and governance processes in place over how a company assesses resilience to a more in-depth working capital review. The audit should continue to assess going concern. However, an audit can never certify that a company is resilient.

03.

Key questions to resolve

Key questions to resolve

While Brydon provides the right framework going forward, policymakers still need to resolve some important implications of the report's key proposals

Going concern period for short-term resilience statements

The time period for the short-term Resilience Statement is only one year, although a longer period is recommended if the Directors consider it is appropriate, up to two years. The current requirements point towards a longer period to assess going concern, which is based on at least 12 months (the period adopted is usually longer). In addition, conditions which exist immediately after the going concern period cannot be ignored in making that assessment. Brydon's determination of one year may result in companies shortening the outlook period used as a basis for which the accounts are prepared. In our view, where only one year is applied, companies should explain why a longer period is not considered appropriate. Events within the 12 to 24 month period, such as a debt repayment or potential covenant breach, are commonly considered under the current requirements.

Accounting and auditing standards would also have to change if the expectation is that directors could set their own short term period. However, we question whether a definitive time cap on the going concern period is appropriate as the appropriate period depends on the circumstances of the company. A longer period of assessment beyond one year is often more meaningful for shareholders. We recommend that further consultation is required on the appropriate period for going concern to avoid outcomes which reduce the usefulness of the going concern disclosures.

Excluding proposed mitigations

Under the existing requirements, companies are permitted to consider appropriate mitigations within their control. This approach allows Directors to give a realistic appraisal of the company's ability to continue as a going concern, with the expectation that such mitigations would be actioned if there was a risk to its survival.

The recommendation to exclude proposed mitigations is likely to result in an increased frequency of material uncertainty disclosures over going concern. While this provides users with more information on the downside risks if those mitigations are not enacted, it may give an unbalanced view of whether that scenario is likely to occur.

This approach could also have unintended consequences if it causes an inefficient allocation of capital, impacting economic growth. Directors may look to unnecessarily increase borrowing facilities to avoid material uncertainty disclosures, for example. In our view, the final disclosure requirements should continue to allow the inclusion of mitigating actions within the company's control. However, Directors need to be accountable to the regulator in demonstrating that those actions are controllable. Company disclosures should be transparent on the beneficial impacts of these countermeasures and any risk that they may not be available to the Directors in the future. The Auditors' report should include detail on how those mitigations have been assessed.

Inconsistencies over what constitutes a proposed mitigation could also arise, particularly when differentiating between those actions, such as cost reductions, which are made in the ordinary course of business in response to market developments, and those measures that may threaten a company's survival if they are not delivered, such as a more significant restructuring programme.

Scope of Assurance

The minimum scope and frequency of the required assurance should be clarified to set clear expectations with users and provide consistency.

Independent assurance over resilience statements

A central challenge for the profession is the belief that the external audit provides a "clean bill of health", which is incorrect. In obtaining further assurance over the Resilience Statement, Directors need to ensure that the work commissioned beyond those procedures required under auditing standards is meaningful for shareholders. Assurance reports will need to provide greater transparency on the work performed and its limitations. For example, the report could include graduated findings over forward-looking judgements by assessing whether the forecasts are optimistic or conservative based on historical performance or whether the scenarios tested were sufficiently severe using industry analysis. Although the current requirements should enhance the information provided, investors would still need to form their own views in making investment decisions, in the knowledge that this will not provide absolute assurance over a company's viability.

Given the existing regulatory responsibilities of the auditor, in our view, it would be impractical and costly for that assurance to be provided by anyone other than the auditor. The time required to oversee the work of a third party would be onerous and it would be unclear where responsibilities lie in retrospect. Although the scope of assurance performed may vary each year, this would be a variable component of the audit. In some cases, this work may require specialist skills to support the audit, and may necessitate the involvement of external experts.

There is a risk that companies may be disinclined to seek additional assurance if that could result in adverse findings. Policymakers will therefore need to assess if a more standardised approach is needed, with a minimum level of procedures and the frequency for completing a more detailed exercise. In our view, an in-depth review should only be undertaken on a periodic basis if there are no adverse changes to the company, its future outlook or its business environment in that year. At a minimum, assurance over the controls and governance process in place to prepare the resilience statement should be completed annually. Additional procedures may be needed where those controls are found to be ineffective.

Regulatory requirements

Reporting obligation for auditors and the role of the regulator

Brydon recommends that the auditor should report to the Board if they have anxieties over a company's resilience not reflected in the Resilience Statement. If the auditor does not consider that the Board has paid enough attention to their concerns, the auditor has an obligation to report that fact to ARGA (Audit, Reporting and Governance Authority - the proposed successor of the FRC).

This builds on existing requirements of ISA UK 570 (Revised) for the auditor to report to the relevant regulatory authority or enforcement agency where it may be necessary to include a material uncertainty paragraph in the audit report or issue a qualified, disclaimer or adverse opinion over going concern.

Arguably, these obligations are easier to meet when dealing with short-term horizons, where the likely risks are easier to foresee for a specific sector or business. Assessing the completeness of potential risks over the medium and longer term, such as technology change, is inherently more difficult. This will increase the degree of judgement needed by the auditor in exercising their reporting obligations. A more precise definition as to the nature of those anxieties raised by the auditor, which trigger this obligation, would also avoid the risk of this term being open to interpretation.

Brydon's recommendations also mean that while the regulator is made aware of any anxieties raised by the auditor, that does not extend directly to the shareholders, particularly outside the going concern period. If the Auditor raises concerns with the Board about the company's resilience, Directors should disclose that fact to shareholders in the Audit Committee Report. This should be accompanied with a clear explanation as to how those anxieties have been considered or responded to by the Directors. Where the Auditor deems those actions to be insufficient, this should be made clear within the audit report as well as to the regulator, on the basis such information is equally relevant to shareholders.

Beyond the auditor's responsibilities, there is scope for the new regulator to take an enhanced role in holding Directors accountable for the information disclosed. This is particularly true where there may be pre-existing concerns about a company's resilience or significant economic repercussions of failure. ARGA should seek and robustly challenge the underlying information used to support the statements made by Directors to capital markets. Resilience statements should be prepared on the basis that ARGA may perform a granular inspection of the information prepared, in the same way that technical accounting disclosures are subject to periodic reviews. This will help drive best practice and identify instances where Directors need to do more to avoid unnecessary company failures.

An investor lens

— In our view, where auditors have concerns that shareholders are being deprived of material resilience information, they should be acting to ensure the public disclosure of that information (or calling out non-disclosure) rather than simply reporting concerns privately to regulators.

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What can be done today?

Critics of the current viability statement do not see it as a serious analysis of a company's future viability, according to Brydon. Although changes will be needed to reporting standards to implement Brydon's proposals, there is scope to improve the way in which Company resilience is reported today using existing requirements. These include:

- Focus on disclosures around the use of mitigations within the existing going concern rules, with greater transparency over whether those actions are within management's control. Long form audit reports should be clear on how those mitigations have been assessed as part of the auditor's going concern review.
- Directors should assess whether the viability report and going concern period cover at least 5 years, in accordance with Brydon's Resilience Statement proposals.
- Increased regulatory focus on going concern and viability disclosures through existing powers to review Annual Reports.
- Specific details of the scenarios tested should be included within Company viability statements to avoid 'boiler plate' disclosures. There should be clear linkages between those scenarios, the risks identified by the Directors and the resilience of the Company's business model.
- The strategic report should provide an integrated view of the business and how it creates value to adequately support the disclosures on future viability. It should include sufficient detail on the Board's assessment of long term threats, such as new technologies, and how the company has responded to those risks for resilience purposes. This could detail any actions the Board intends to take.

IFRS disclosures

In our view, resilience statements can build on financial reporting rather than act as a substitute. IFRS financial reporting provides important insights into entities' prospects for future cash flows, helping users to assess corporate resilience. Financial statements disclosures should provide sufficient detail to provide those insights through existing requirements, in conjunction with a separate resilience statement.

04.

Preparing a Resilience Statement

What to consider

To help preparers think ahead about how they may deal with Brydon's recommendations, we have outlined below some key questions to consider when preparing a Resilience Statement:

Key questions for preparers

- How does the purpose, strategy and business model align to the key drivers of the company's market value and how resilient is the business to any downside valuation risks?
- What time horizons have been considered when determining your principal risks and how do these evolve over time (e.g. like climate change)?
- Is one year an appropriate period for the short term statement? Are there risks to going concern immediately after the period of assessment that should be included e.g. re-finance in 13 months?
- How does the period of the medium-term statement relate to the company's budgeting and strategic planning periods, and how scenario testing can be performed on what may be a different period?
- Over what time horizon should long-term resilience therefore be assessed based on emerging threats and what level of detail should be provided based on different time horizons?
- What is the strategy to respond to long-term risks as they emerge?
- How do you measure resilience for your business both qualitatively and quantitatively based on its principal risks and business environment? For example, this could include liquidity metrics, margin measures or capital ratios.
- How do those measures align to other performance measures already reported? For example, the success rate in securing new contracts or customers.
- What sort of stress tests are most appropriate in response to the risks identified? This could include which risks to test in combination, or the use of reverse stress testing in addition to declared scenarios.
- How much detail is provided on the scenarios tested to provide transparency without obscuring the most important information?
- How complex are the underlying calculations and judgements - does that warrant further assurance for shareholders and what is the appropriate scope of that assurance?
- What controls and governance processes are in place around the preparation of the Resilience Statement?
- What is the appropriate scope of assurance based on the company's risk profile in the absence of any new auditing requirements or standards?

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Pulling it all together

Preparing a robust Resilience Statement is about more than meeting a new disclosure requirement. It should drive better company performance through enhanced risk assessment, resilience measures and strategic decision making that enhances shareholder value and helps prevent failures.

Preparing a robust Resilience Statement requires a structured approach. There are many aspects to consider and it should be an iterative process. The diagram below aims to capture some of those aspects to help pull it all together.

05.

Conclusions

Our Conclusions

Providing shareholders with more information over the resilience of a company has never been more important and the Brydon proposals move the debate in the right direction. Recent economic shocks such as COVID-19, and the importance of emerging threats like climate change, have brought this into sharp focus.

The current viability requirements do not provide sufficient transparency or a long-term view of the resilience of a company's business model. In addition, the level of disclosure around risk management, including the controls and governance processes in place to manage those risks, could be enhanced. Directors need to be accountable for those statements and the regulator also has a role to play in challenging Directors on their assessments.

We therefore support Brydon's proposals for a Resilience Statement to improve existing disclosure requirements. The new statement will require Boards to demonstrate that the company can withstand difficulties as well as prosper in an increasingly uncertain world. It also links the concepts of going concern with an assessment of whether the company is resilient to risks over the medium and long term. However, policymakers need to ensure the final requirements meet the desired objectives, without causing unintended consequences, which may result in a less efficient use of capital or Directors becoming overly risk averse.

Auditors have a key role to play in providing the confidence shareholders need in the information disclosed. That includes providing separate assurance reports over the controls, calculations and judgements underpinning these new statements about resilience beyond the going concern period. This can significantly strengthen the attractiveness of the UK's regulatory environment to investors. The final audit requirements should reflect the size, nature and public profile of the audited entity.

Directors also need to consider how company disclosures made under the existing requirements can be improved in response to Brydon's recommendations, particularly for short-term resilience, risk reporting and where future assumptions are applied in preparing financial statements. An effective auditor can, and should, provide robust challenge on these areas through their existing remit.

In our view, Brydon's proposals provide an important road map to enhance the role of the auditor to be more forward looking, but further refinements around going concern, regulation and assurance are needed to set clear expectations with users on what that assurance provides.

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