Viability statements: the role of internal audit

This is the second of five pieces from an internal audit perspective on the 2018 UK Corporate Governance Code: Non-executive recruitment (1), Viability statements (2), Audit committee effectiveness (3), Culture (4) and the Workforce voice (5).

In 2014 the UK Corporate Governance Code introduced new requirements in respect of the reporting of the board's views on the principal risks and longer-term viability of the company. It is part of the strategic report to investors and unlike the going concern statement which is limited to the year ahead addresses the long-term health of the organisation.

So why cover it now if it's not new?

There is increasing pressure for investors to be more active in their portfolio of organisations. With its long-term perspective the viability statement is therefore high profile and of growing importance to boards. So how do boards gain assurance on its adequacy? Perhaps it is already on the audit plan but more likely it isn't. The question is, should it be? We believe so.

Some chief audit executives may consider this the realm of the external auditors. The Institute is confident that its internal auditors have the skills to provide assurance over the front end of the annual report; including the viability statement.

This paper will explore what a good statement looks like, the process behind it and the provision of assurance. Although the Code is for the private sector, audit leaders in not-for-profit organisations will also recognise the importance of viability and the increasing transparency that stakeholders expect.

RECAP. On 16 July 2018 the Financial Reporting Council (FRC) published its long awaited update to the UK Corporate Governance Code together with revised Guidance on Board Effectiveness.

The revisions support the government's vision of restoring trust in the corporate organisations and the broader social reform agenda which aims to improve the standard of living and quality of life for ordinary working people.

Provision 31 - taking account of the company's current position and principal risks, the board should explain in the annual report how it has assessed the prospects of the company, over what period it has done so and why it considers that period to be appropriate. The board should state whether it has 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.

Why internal audit?

Let’s address this by looking at tradition. Internal audit (IA) has a broad remit as defined in its charter; governance, risk management and internal controls. There is no other internal function that can provide a holistic, independent, objective and trusted opinion to the board. The remit of external audit (EA) is much narrower focusing on the ‘true and fair’ reporting of past financial performance and current financial position.

Viability statement assurance is new territory to which both parties have a claim; IA because it is risk-based and part of the non-financial report, EA because of the financial modelling.

A SAB Miller case study in a 2015 Chartered Institute research report recognised the value to the board of EA and IA providing independent assurance for the strategic report. A stretch challenge for both parties as it goes beyond their traditional comfort zones. IA has detailed insight into the principal risks to provide genuine challenge to the viability statement as part of this.

Corporate governance is still evolving and IA has an important role in supporting their boards; remember the Turnbull report that really kicked it all off was only published in 1999.

What does a good statement look like?

The Guidance on Board Effectiveness provides practical advice on implementing the Code. There are questions for the board to consider and expectations (para 123-8) for the viability statement:

1. *determining the period that the statement covers*
   As detailed in FRC guidance, factors in addition to the strategic plan may include; investment and planning periods, the board’s stewardship responsibilities, the nature of the business and its stage of development, as well as previous statements made, especially in raising capital.

2. discussing the period that the statement covers with investors
   Organisations can determine their own time period although an informal standard of 3-5 years has evolved. Research by the Investment Association found that investors would often value a longer timescale more reflective of an organisation’s sector/business model.

3. *consider impact on principal risks on longer-term prospects*
   It is important that the risk management process is robust. Incomplete risk information compromises the viability statement principal risks must be specific to the organisation not just external/environmental points that investors will already be aware of.

4. *qualify that the company can meet its long-term liabilities and continue operating*
   In effect this is like an extended version of going-concern. It should take into consideration analysis of funding, cash-flow, investments, major projects, research and development etc.

5. *explain analysis that supports the statement*
   Good practice includes an overview, not commercially sensitive detail, of process such as scenario planning, modelling assumptions, stress testing, funding forecasting, sensitivity analysis, board risk workshop etc.

We recommend that auditors look at a variety of annual reports to understand how viability statement are reported as they vary considerably; for instance in their 2017 report British American Tobacco linked the statement to their principal risks, National Grid provided a detailed account of their key steps (p26) and both J Sainsbury's (p45) and Johnson Matthey (p74) included details of scenarios.

There are also sector differences to consider, for example the housing sector has a requirement to provide both a financial and a governance viability statement annually to the regulator.

Is there a process that achieves this?

FRC research into Risk and Viability Reporting 2017 remains an important document and provides detail of the two stage process defined as good practice.

Image taken from Risk and Viability Reporting 2017 report

The process is essentially one of data gathering, analysis and reporting.

How can internal audit provide assurance?

There are a range of assurance options that IA can provide to the board in relation to the questions the FRC encourages. We focus here on the viability statement but the wider strategic report should also be included. The assurance may not necessitate a full report; an email or memo may suffice.

The Guidance on Board Effectiveness suggests questions for the board to consider; these are also useful for IA in providing assurance when combined with the key expectations of the statement.

- Is there consistency between the directors' assessment of long-term prospects and the statement on the company's viability?
- How comprehensive was the information that informed the statement, such as considering previous statements in respect to raising capital, the nature of the business and its stage of development, and investment and planning periods?
- How robust is the principal risk process?
- What was the process for the stress testing/scenario analysis? Was data complete and accurate? What qualifications and assumptions were made?
- What safeguards were in place to avoid bias and ensure the viability statement was produced independently of other statements such as going-concern, financial covenant and pension funds?

There are a plethora of commercial and creative pressures in the preparation of the non-financial report. As trusted advisors heads of internal audit are uniquely positioned to provide a 'sense check' on the content in addition to assurance over accuracy of data, stakeholder input, transparency or the end-to-end creation process.

How well has your organisation embraced the concept of integrated reporting for the strategic report? Engaging with governance leaders on the importance of this tool to communicate with external stakeholders and protect/promote the reputation of the organisation is a valid role for IA.

If IA is not providing assurance for the strategic report, who does? Design agencies do not understand the content, EA do not have sufficient corporate knowledge and the first/second line wrote it. Heads of internal audit can play devil's advocate – is the language reader-friendly, does it reflect the business model, are the CEO and chairman honest in their appraisal? A challenging standpoint that only senior audit leaders can perform.

Closing Thoughts

The viability statement of itself is a small part of the annual report and the governance code. Yet it is a powerful commitment and the process to arrive at it has the potential to truly embed the ideal of good governance. Heads of internal audit, talk to your audit committee chair ahead of year end. Why wouldn't you want to position yourself to provide unique assurance and add value to board decision-making?

> *Unless you try to do something beyond what you have already mastered, you will never grow*
> *Ralph Waldo Emerson, Philosopher*

Further reading

2018 UK Governance Code
2018 Guidance on Board Effectiveness
2011 Davies Report - Women on Boards
2009 The Walker Review - UK Banking Governance
2003 Tyson Report - Non-Executive Recruitment
2003 Higgs Report - Effectiveness of Non-Executive Directors