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The Deloitte Academy
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Governance *in brief*

Brexit and viability disclosures – a timely reminder

Headlines

- The FRC is calling for clear reporting on the potential risks arising from Brexit, and how companies are managing those risks. In its Annual Review of Corporate Reporting, published in October, it called for directors to be specific about how Brexit risk challenges company business models. It called for clear explanation of the impacts to sensitivity analyses on cash flows and whether Brexit uncertainties impact statements on viability, and even potentially on the company's position as a going concern.
- As we are all aware, there remains considerable uncertainty regarding the final outcome of the Brexit negotiations and therefore as we enter the 2018/19 reporting season companies may well be issuing annual reports, including a longer term viability statement, without a clear picture of the UK's eventual position.
- Our 2018 Annual Report Insights survey revealed that few companies in our sample mentioned Brexit in their viability statement as a scenario they tested. Much more attention is expected on Brexit disclosures from directors, auditors and investors this year end.

Background

Article 50, the mechanism for leaving the European Union, was triggered on 29 March 2017, meaning that by operation of law, the UK will leave on 29 March 2019.

If there is no deal reached between the UK and the EU, the UK would exit without a transition period and trade will default to WTO (World Trade Organisation) rules and associated tariffs. In this scenario, there would be an end to the free movement of people, and the UK would fall out of any agreements with third countries that existed as part of its membership of the EU, if it has not been able to roll them over into continuity agreements.

If a deal is reached including a transition period, this would largely resemble the current status quo, as if the UK were still in the Single Market and Customs Union. However, the UK will have no voting rights in the EU processes and will be required to abide by any changes to EU rules. During a transition period, the UK will be able to negotiate and sign new trade agreements but cannot apply them, and whilst the UK will still be bound by the obligations of third country EU agreements, reciprocity of the benefits is not guaranteed. The range of possible scenarios means that companies have struggled to know the best way to prepare for potential challenges.

However, many have now established the nature of the most significant challenges. In some cases, contingency plans sit ready to be implemented, in others they are already being executed. This is the backdrop against which companies are preparing annual reports, including a longer term viability statement looking out over 3-5 years.

Our research shows that comparatively few companies have so far mentioned Brexit in their viability statement, either as part of the scenarios they test or as an assumption underlying their supporting analysis. From the 2018 reporting season, there was also little evidence that companies have built the multiple uncertainties of a wide-ranging Brexit impact into their forward-looking forecasts. Therefore, as we approach the 2019 reporting season, in this Governance in brief, we provide a reminder of the requirements of the longer term viability statement, highlight the key challenges directors will face in their analysis and encourage modelling that has the flexibility to consider different options as the UK approaches either a deal or no deal scenario.

What are the responsibilities of directors and auditors regarding principal risks?

The requirements for directors of premium listed companies are set out in the 2016 UK Corporate Governance Code, provision C.2.1:

The directors should confirm in the annual report that they have carried out a robust assessment of the principal risks facing the company, including those that would threaten its business model, future performance, solvency or liquidity. The directors should describe those risks and explain how they are being managed or mitigated.

The auditor is required to comment if they have anything material to add or draw attention to in respect of principal risks and uncertainties, and the viability statement.

Viability statement requirements

The requirements for the longer term viability statement come from 2016 Code provision C.2.2. and are given further legal force by Listing Rule 9.8.6R.

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.

Directors should remember that the FRC is calling for a clear distinction between the much longer period over which directors should assess longer term prospects (taking perhaps a ten to twenty year view or longer depending on the nature of the business) and the 3-5 year period for the viability statement.

The key steps required can be set out in a series of decisions to be taken by the board and in the reporting requirements in the annual report.

Decisions

1) The lookout period – both for longer term prospects and for viability

2) Which principal risks should be factored into the analysis in terms of impact and timing

3) What will be the nature and extent of supporting analysis the board will want to see

4) What qualifications or assumptions to disclose within the statement, if any

5) The location of the statement in the annual report

Reporting requirements

1) An explanation of how the directors have assessed the longer term prospects of the company

2) The lookout period for the viability statement and why the directors consider that period to be appropriate

3) How the analysis has been performed

4) A statement that the company will be able to continue in operation and meet its liabilities as they fall due over the lookout period for the viability statement

5) Plus, any qualifications or assumptions as necessary

Direction of travel

At this stage there is no agreed deal between the EU and the UK, meaning that for December year ends, there was no clarity on whether there would be a deal prior to the year end. However, there may yet emerge some clarity before the annual report is signed.

With critical decisions and implementations so close at hand, directors will need to mention Brexit and explain what assumptions have been built into their forecasts, especially regarding liquidity and cash flows.

This is something that the auditors will also need to consider, given their responsibility under auditing standards to confirm in their audit report whether they have anything material to add or draw attention to with respect to the directors' reporting on risk and the longer term viability statement.

The Brexit challenge

Although many companies have set up teams responsible for tracking the potential impacts of Brexit and reporting their findings to the board, these teams are not generally involved with the viability statement. So preparers of the annual report and the viability statement will need to engage actively with those who are working on the company's response to Brexit, to understand and build into their sensitivities and scenarios the most significant potential impacts on the business – remembering that the requirement is for consideration of "severe but plausible scenarios". This will vary business by business – some of the key areas of impact we believe businesses should consider are below.

Of course, depending on the timing of the year end and the annual report approval date, the "severe but plausible" scenarios for the company may change.

For instance, if a deal has been agreed and the transition period of 21 months kicks in, there will be a period of less supply chain friction with the EU – however the end of that transition period will still likely be within the lookout period of between 3 and 5 years set by most companies and there remains a scenario by which the UK could still exit the transition period without full and final agreement on its future economic relationship with the EU.

Assumptions need to be made to allow the risk to be quantified. And of course this risk needs to be considered in combination with the other principal risks.

Increased collaboration between the team or individuals with greatest visibility of the Brexit impacts on the company, the Chief Risk Officer and their team and those who are involved in preparing analysis or drafting the annual report will both strengthen the quality and specificity of the risk identification, and also increase the effectiveness of scenario modelling – and in addition, will bring Brexit alive as a business risk rather than reporting issue.

Key areas of impact	
Labour Mobility	• Low skilled labour shortage • Difficulty in accessing talent
Supply Chain Friction	• Contract risks – who is liable under contract for delays, increased tariff and border costs. Costs to business to review and/or re-negotiate terms • Delays at border and compliance costs • Increased cost of stock-piling and warehouse space
Customs Tariffs	• WTO no deal = introduction of tariffs • Loss of access to EU-Third Country FTAs – for example, CETA and Japan EPA – increase costs due to loss of preferential tariff rates • Increase cost of classification systems; IT; origin management
Regulatory and Policy	• Loss of mutual recognition of data standards – data flow disruption between UK-EU and UK- third countries where EU adequacy agreements are in place, including Canada, US (Privacy Shield), NZ, Israel. Costs of data flow disruption; set up of new data centres • Loss of market access where typically business rely upon single market authorisation - for example Pharma (EMA); Chemicals (ECHA); Financial (passporting rights) – cost of dual-marketing authorisations to maintain access to UK and EU markets
Tax	• Potential increase in withholding tax • Reliance on double tax treaties as opposed to EU directives • Changes to VAT accounting; working capital requirements; cash flow
Macroeconomic	• Drop in value of sterling; FX changes; potential decrease in valuation of assets

What should the board do?

The most important thing the board can do is to make sure that forecasting, for near-term planning as well as for longer term viability, incorporates very clear scenarios around the potential impacts of Brexit on their business.

Due to the uncertainty, this will involve management running several scenarios which can be refined and finalised as critical milestones change or pass, and ensuring that sufficient time has been allocated in board or audit committee meetings to challenge the scenarios selected, the related forecasts and appropriate sensitivities. Where sensitised forecasts show a short term impact on liquidity and cash flows, not only the longer term viability statement but also going concern should be examined with rigour.

Changes in cash flow assumptions should also be reflected in forecasts as either base case or sensitivity scenarios used in the annual impairment reviews to test the carrying value of assets for annual reporting. In extreme circumstances Brexit could represent an existential threat to a company's business model and its ultimate survival.

In extremis, boards which consider their company to be particularly exposed in the event that no withdrawal agreement is reached may wish to keep the reporting timetable under review and potentially to amend planned announcement dates.

Some questions for directors to consider

- Do we truly understand the impact that Brexit could have on our business – our strategy, business model, cash flows, and tax and statistical reporting systems?
- Have we articulated the nature of the company's Brexit risks clearly, and if these are material have we developed an effective plan?
- Have we built into that assessment the broader risks to the economy and availability of workforce?
- If Brexit has not been classified as a principal risk before, should it be classified as such this year?
- Are we satisfied that our contingency plans are sufficiently robust and is our description of how we are mitigating the risks truly reflective of the state of our contingency planning?
- Have Brexit impacts been assessed in our longer term viability statement scenarios? Have we stress tested this in combination with other principal risks?
- Is the board satisfied that the scenarios used by management to model the impact of Brexit on the company are complete and their impact upon the business is considered to be realistic?
- Is our liquidity and cash flow secure in even our worst case Brexit impacts? If not, do we have strategies or contingency plans to mitigate the risk and remain viable?
- Is there any impact from Brexit scenarios on the carrying values of assets? If material, consider disclosing assumptions and material uncertainties.
- Has management considered how competitors are managing their Brexit risk and whether particular companies have competitive advantage as a result?

Deloitte view

- Boards should ensure that management brings Brexit into forecasts in the same way as other principal risks, rather than relying on uncertainty or an assumed final deal as a reason to leave it out. Key impacts need to be recognised and assumptions made and quantified.
- The timing of company reporting against the Brexit timetable is going to be a challenge and the best processes will recognise this challenge and flex scenarios so that there is a clear answer whatever stage the negotiation has reached.
- Where there could be a significant impact on liquidity or cash flows, not just longer term viability but also going concern should be examined with rigour, as well as the uncertainty in cash flows used for evaluation of carrying values of assets in impairment reviews.
- Remember that the auditors will be asking questions of management and will require clarity of thinking around the Brexit scenarios considered and the sensitivities performed.
- Disclosures need to be carefully drafted, perhaps envisaging a number of scenarios. Critically, even if the board concludes that there is no significant impact on the company's business model, this should still be documented internally and disclosed to avoid the appearance of lack of assessment of the risk.

Contacts – Risk Advisory

Deloitte's Risk Advisory team works with clients to help them manage risk and create value. The team works collaboratively with client organisations to either assess existing processes in place or to assist in the implementation of pragmatic risk solutions.

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Contacts – Brexit

Deloitte is a leading voice in navigating Brexit considerations with business and government. Our central Brexit team has a wide range of specialisms to support organisations in understanding the issues and identifying both the risks to your business and the potential opportunities.

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The Deloitte Academy

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Members receive copies of our regular publications on Corporate Governance and a newsletter. There is also a dedicated members' website **www.deloitteacademy.co.uk** which members can use to register for briefings and access additional relevant resources.

For further details about the Deloitte Academy, including membership, please email **enquiries@deloitteacademy.co.uk**.

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