Company Guidance (Updated 20 May 2020) (COVID-19)

COVID-19 Pandemic

Guidance for companies on Corporate Governance and Reporting (Including Interim Reports)

Many companies are facing unprecedented uncertainty about their immediate prospects in an environment which may challenge or disrupt their usual management and governance processes.This uncertainty is likely to decrease over time as more information becomes available about COVID-19, the length and extent of social distancing restrictions in different countries, access to financial support measures made available by the UK and other governments, and the impact on the economy. The FRC encourages companies, as appropriate, to make use of the extension announced by the FCA to the deadline for publication of audited annual financial reports from four to six months from the end of the financial year. At the same time companies should continue to provide information to investors on the areas of most immediate interest to them.

In this paper, we highlight some key areas of focus for boards in maintaining strong corporate governance and provide high-level guidance on some of the most pervasive issues when preparing their annual report and other corporate reporting.

Our key messages to boards on corporate governance are to:

- develop and implement mitigating actions and processes to ensure that you continue to operate an effective control environment, addressing key reporting and other controls on which you have placed reliance historically but which may not prove effective in the current circumstances;
- consider how you will secure reliable and relevant information, on a continuing basis, in order to manage the future operations, including the flow of financial information from significant subsidiary, joint venture and associate entities; and
- pay attention to capital maintenance, ensuring that sufficient reserves are available when the dividend is paid, not just proposed; and sufficient resources remain to continue to meet the company's needs.

Making forward-looking assessments and estimates when preparing financial statements and providing other corporate reports is particularly difficult currently. The following guidance is intended to help boards focus on areas of reporting of most interest to investors; and to encourage them to provide clarity on the use of key forward-looking judgements. The guidance covers:

- The need for narrative reporting to provide forward-looking information that is specific to the entity and which provides insights into the board's assessment of business viability and the methods and assumptions underlying that assessment;
- Going concern and any associated material uncertainties, the basis of any significant judgements and the matters to consider when confirming the preparation of the financial statements on a going concern basis;
- The increased importance of providing information on significant judgements applied in the preparation of the financial statements, sources of estimation uncertainty and other assumptions made; and

- Judgement required in determining the appropriate reporting response to events after the reporting date and the extent to which qualitative or quantitative disclosures may be appropriate.

Corporate Governance

In these difficult times, the need for clear leadership, strong governance and effective decision making based on reliable information is stronger than ever.

The disruption to working practices and the changing resource demands will have led to the need for new forms of management and control. Such changes are inevitable, but boards are advised to consider the following matters and ensure plans are in place to address them.

Management information

The usual flows of management information through a group or company or from associates and joint ventures may have been disrupted. Boards must consider how they can maintain and/or complement this missing information as they plan their route through the current emergency towards reactivation of their full business activities. This flow of information will also be important for preparing the published financial statements.

Risk management and Internal controls systems

Relocation of staff and the inaccessibility of some business locations may lead to risk management processes and internal controls becoming unworkable or otherwise relaxed. Such changes may be unavoidable or considered necessary in the short-term to maintain some level of operations.

However, we urge boards to monitor such changes carefully, introducing alternative mitigating controls where necessary and practicable to support the operation of an effective control environment.

Dividends and capital maintenance

Many companies have already adjusted their approach to dividends and their shorter-term dividend policies to support their balance sheets and provide financial flexibility. For those companies that have proposed but not yet made a dividend (declared by the members in general meeting for a final dividend or by payment for an interim dividend), directors need to consider not only the position of the company when the dividend was proposed but also when it is made. Where the company is no longer able to pay a dividend, directors should halt any dividend and communicate as appropriate to the market.

The assessment of whether a dividend is appropriate should include consideration of current and likely operational and capital needs, contingency planning and the directors' legal duties, both in statute and common law. Directors must ensure that the capital maintenance rules of Part 23 of the Companies Act 2006 are complied with, that they fulfil their duties under Section 172 of the same act and that due consideration is given to their fiduciary duties to ensure the company will be able to pay its debts as they fall due.

In some cases, it may be necessary to move funds around a group, using inter-company dividends from subsidiaries to their parent companies or capital contributions between companies. Once again directors must ensure that such transfers comply with statute and the common law duties of directors.

Corporate Reporting

Investors have highlighted that their key information needs relate to the liquidity, viability and solvency of companies. Boards cannot predict the extent and duration of the COVID-19 pandemic nor its consequences for the global economy. It is however reasonable for investors to expect companies to be able to articulate their expectations of the possible impacts on their specific business in different scenarios.

Investors and other users of corporate reports want to understand a company's resilience in the face of current uncertainty and to understand the key assumptions and judgements a board is making when assessing resilience and in preparing company financial statements.

Of particular importance is the availability of cash within a group of companies, the ability to transfer such resources around the group to where it is needed, given operational, regulatory and legal constraints, and the access to further cash through existing and potential financing facilities.

Strategic Report and Viability Statement

The Strategic Report should always be forward looking, and especially so during the current crisis. It should also be entity-specific – COVID-19 is affecting all businesses and individuals but the critical implications for individual companies may differ, as will their plans to mitigate some of the effects, their capacity to follow these plans and the level of resources available to withstand the effects that remain.

In setting out its principal risks and uncertainties, a company should consider the specific resources, assets and relationships that are most under threat and the steps being taken to protect them. The protection and retention of staff, and the associated corporate memory, may be crucial to a company's ability to weather the current storm and to rebuild when the opportunity arises. All stakeholders, including investors, are concerned about companies' workforces and seek an understanding of how they are being retained and supported.

Given the systemic uncertainties that currently exist, many boards will be less confident in stating that they have a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due over a period of assessment ("the viability statement" as required for compliance with the UK Corporate Governance Code).

However, the FRC stresses the following points:

- Boards are required to have a "reasonable expectation" of the company's viability over the period of assessment – during the current emergency and unprecedented pace of change, any reasonable level of expectation would naturally carry a much lower level of confidence;
- Being clear on the company's specific circumstances and the degree of uncertainty about the future is important information; and
- When presenting a company's viability statement, its board should draw attention to any qualifications or assumptions as necessary.

In describing any qualifications to the statement, a board should describe the limits of the predictions, the level of confidence with which they have been made and the uncertain future events that could prove critical to viability.

Similarly, the key assumptions made and the future scenarios considered should be explained. Many companies already use scenario and stress testing in developing their statements and this should continue as far as practicable. The use of reverse stress testing, to identify future scenarios that could lead to corporate failures, is also good practice.

At this time, the need for fuller disclosure is paramount.

Financial Statements

Going concern and material uncertainties

IAS 1 requires financial statements to be prepared on a going concern basis unless management either intends to liquidate the entity or to cease trading or has no realistic alternative but to do so.

The FRC thinks it is likely that more companies will disclose “material uncertainties” to going concern in current circumstances. This term may not be widely understood. It refers to uncertainties related to events or conditions that may cast significant doubt upon the entity’s ability to continue as a going concern. In other words, if boards identify possible events or scenarios (other than those with a remote probability of occurring) that could lead to corporate failure, then these should be disclosed. When identifying such events or scenarios, boards may take account of realistically possible mitigating responses open to them. Events could lead to corporate failure because of the scale of their adverse impact on the company and its ability to avoid liquidation or because of their timing.

When assessing whether material uncertainties exist, boards should consider both the uncertainty and the likely success of any realistically possible response to mitigate this uncertainty.

These assessments are significantly more difficult currently given the uncertainties about the impact of COVID-19, the extent and duration of social distancing measures, the impact on the economy and asset prices generally. Boards should consider the potential impact of these matters on the company’s specific circumstances, paying attention to their current and potential cash resources, including access to existing and new financing facilities, revolving facilities, invoice discounting and reverse factoring. The company’s access to and use of such facilities should be disclosed appropriately.

Boards should also consider their access to government support measures that have been announced.

- We encourage boards to consider the impact of different potential scenarios (e.g. consideration of different time periods for the continuation of social distancing) on their company’s revenues, costs (both fixed and variable) and cash flow requirements.Some official sector bodies in the UK and globally (e.g. the UK Office for Budget Responsibility, the International Monetary Fund and the OECD) have produced projections for economic activity that companies may use as an anchor for their own scenarios.
- If a material uncertainty does exist, then the company should disclose it in terms that are as specific to the entity as possible. Users will wish to know how and when the uncertainty might crystallise and its impact on the resources, operational capacity, liquidity and solvency of the company.
- If the board concludes that there is not a material uncertainty that meets the criteria for disclosure, but this conclusion required the application of significant judgement, then this judgement should be disclosed in accordance with paragraph 122 of IAS 1. The IFRS Interpretations Committee (then IFRIC) explained this requirement in an agenda decision set out in the July 2014 IFRIC Update. Providing such disclosures will help meet the information needs of financial statement users to understand fully the pressures on liquidity, viability and solvency.

Significant judgements and estimation uncertainty

Given the inherent uncertainties in making predictions, we have stressed above the need to disclose underlying assumptions applied when preparing a viability statement, and any significant judgements made when assessing whether there are material uncertainties to disclose.

Similarly, companies should disclose significant judgements made in applying accounting policies that have the greatest effect on the financial statements. The requirement to do so (IAS 1 paragraph 122) is normally distinguished from the requirement of IAS 1 paragraph 125 regarding sources of estimation uncertainty. However, at this time, we encourage companies to provide as much context as possible for the assumptions and predictions underlying the amounts recognised in the financial statements, irrespective of any narrow interpretation of the requirements. Such information will help users to understand the amounts presented.

Relevant judgements and assumptions might include the:

- availability and extent of support through government support measures that have been announced;

- availability, extent and timing of sources of cash, including compliance with banking covenants or reliance on those covenants being waived;
- duration of social distancing measures and their potential impacts.

In the absence of any consensus view of the future path of the COVID-19 pandemic and its impact on the economy, users cannot expect all companies to apply consistent assumptions when there is such uncertainty. This lack of consistency makes the need for full disclosure of judgements, assumptions and sensitive estimates significantly more important than usual.

Events after the reporting date

IAS 10 distinguishes between those events occurring after the balance sheet date that provide more information about the conditions that existed on the balance sheet date ("adjusting events") and those that are indicative of conditions that arose after the balance sheet date ("non-adjusting events"). Amounts in the financial statements must be adjusted in response to adjusting events whilst only disclosures are required in response to material non-adjusting events.

There is a general consensus that the outbreak of COVID-19 in 2020 was a non-adjusting event for the vast majority of UK companies preparing financial statements for periods ended 31 December 2019. Companies will need to judge how much of the impact of COVID-19 should be considered to arise from non-adjusting events for subsequent reporting dates. This will be highly dependent on the reporting date, the specific circumstances of the company's operations and the particular events under consideration.

In reaching this judgement, companies will need to focus on the importance of the conditions at the balance sheet date – does the event shine a brighter light on those conditions or did conditions change after the reporting date? If the judgement had a significant effect on the amounts in the financial statements, then this judgement should be disclosed and explained.

If an event is considered to be non-adjusting, then the nature of the event should be disclosed. Where an estimate of the financial effect on the company can be made, then this should be disclosed. Otherwise the fact that the financial effect cannot be estimated should be disclosed. The estimate does not need to be exact – a range of estimated effects is better than no quantitative information at all. In the absence of any quantitative estimate, a qualitative description should be provided.

Exceptional or similar items

As required by IAS 1, many companies disclose individually material items on the face of the income statement or in the notes to their accounts. Companies will need to consider whether additional items of income and expenditure arising from the Covid-19 crisis should be separately disclosed in accordance with their existing policies for 'exceptional' or other similar items. The materiality of items such as restructuring costs, impairment charges, incremental health and safety costs, and the costs of onerous contracts will need to be considered by each company. The nature and amounts of any such items should be presented in a way that is helpful to readers; for example, by giving them all in a single note or linking them with cross-references. Information about the effect of these or similar items on cash flows, and their timing, and tax will also be relevant to readers.

Companies should:

- be even-handed in identifying any gains as well as losses;
- not describe amounts as 'non-recurring' or 'one-off' if they are also expected to arise in future periods;
- not disclose costs (sometimes described as 'stranded', 'sunk' or 'excess') as exceptional solely because of a reduction in, or elimination of, the related revenue streams due to the Covid-19 crisis; and

- not identify incremental costs as exceptional if they result in incremental revenue that is not also described as exceptional; for example, additional staff costs related to managing unusually high levels of sales of in-demand items.

Some effects of Covid-19 will be pervasive and hard to quantify. In these circumstances, it is helpful to provide narrative disclosures explaining the nature of the items and the uncertainties around them. However, splitting discrete items on an arbitrary basis in an attempt to quantify the portion relating to Covid-19 is unlikely to provide users with reliable information. We discourage companies from disclosing these in their accounts.

Some companies present sub-totals on the face of their income statement which adjust for exceptional or similar items. IAS 1 permits sub-totals to be presented if they are relevant to understanding a company's financial performance. These must only be comprised of line items made up of amounts recognised and measured in accordance with IFRS. Accordingly, presenting a sub-total derived on a hypothetical or 'pro-forma' basis (for example, by adding back an estimate of 'lost' revenue), either as a line item or in a 'third column' format, would be inconsistent with the requirements of IAS1.

Alternative Performance Measures ('APMs')

Companies often use APMs in their interim and Annual Reports and Accounts to supplement information provided under IFRS. These frequently include measures such as profit adjusted for exceptional or similar items. Companies are expected to provide APM disclosures that:

- have clear and accurate labelling;
- have an explanation of their relevance and use;
- are reconciled to the closest IFRS measure; and
- are not given more prominence than the equivalent IFRS measures.

APMs should also be presented consistently year-on-year. However, there may be circumstances where the Covid-19 crisis has, for example, resulted in a company's making changes to its operations or business model. These may result in changes to the APMs used to run and monitor the business. In these circumstances, readers should be informed of any such changes and provided with an explanation of why they provide reliable and more relevant information.

APMs which attempt to provide a measure of 'normalised' or 'pro-forma' results, excluding the estimated effect of the Covid-19 crisis, are likely to be highly subjective and, therefore, potentially unreliable. In addition to the subjectivity arising around which costs to exclude, in most cases Covid-19 is likely to have resulted in reductions in revenues. Any adjustment for lost revenues would be hypothetical and could not be reflected reliably in an APM. We do not expect companies to provide these measures; for example, by including them in a 'third-column' income statement presentation.

Interim reports

Directors will need to exercise judgment about the nature and extent of the procedures that they apply to assess the going concern assumption at the half-yearly date. This might include disclosures of: any material uncertainties to going concern; assumptions made about the future path of COVID-19 and the public health responses; the projected impact on business activities; use of government support measures; and access to bank and other financing.

Issues which might trigger a need to re-examine the going concern assumption and going concern and liquidity risk disclosures include:
• a significant adverse variation in operating cash flows between prior budgets and forecasts and the outturn in the first half of the year;
• a significant reduction in projected revenues for the second half of the year based on plausible

scenarios for the COVID-19 pandemic and public health responses, and taking into account government support measures;
• a failure to obtain renewal or extension of committed financing facilities; and
• a failure to sell capital assets for their expected amounts or within previously forecast time-frames.

If going concern has become a significant issue since the previous annual financial statements, directors should undertake procedures similar to those that they would have carried out for annual financial statements to ensure that all relevant issues have been identified and considered.

It is a matter for a company to decide whether to engage their auditors to perform an interim review engagement– it is not a legal or regulatory requirement. However, feedback we have received from investors indicates that such a review provides valuable assurance, and this may be particularly so in the current environment.