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Risky business: UK plc assesses its viability

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In 2014, the Financial Reporting Council (FRC), the United Kingdom's independent regulator responsible for promoting high-quality corporate governance and reporting, introduced a requirement that companies include a Viability Statement in the annual report to provide investors an improved and broader assessment of long-term viability.

The new requirement has resulted in a flurry of activity as UK-listed companies seek to better understand the financial implications of their risk exposure. We interviewed the CFOs, company secretaries and controllers of 17 leading companies – ranging from utilities and insurers to retailers and pharmaceutical companies – to understand how the Viability Statement's introduction has changed their treatment of risk.

Unsurprisingly, financial institutions[1] – as required by their regulator – have all the tools in place to model risk. The benefit of the Viability Statement exercise in some cases was a board discussion where the various pieces of risk modelling were brought together and considered in an integrated manner. For non-financial corporates, many had never before modelled the impact on their financials of a downside outlook for one or more of their risk variables. Indeed, many still do not model one-off events (for example, a cybersecurity attack), citing the complexity of quantification – favouring instead continuous economic variables like GDP growth. Furthermore, most non-financial companies do not yet inform their strategic decision making with insights from the Viability Statement exercise. This also points to an opportunity: companies have substantial scope to further enhance their understanding of risk and potentially reshape their strategic posture as a result.

From Wall Street to Main Street

The global financial crisis of 2007-2008 forced the financial sector and its regulators to recalibrate their perception of risk: how much is too much? Regulators have imposed stress-testing regimes on banks and insurers, examining their ability to survive major changes in their operating environment. For the most part, non-financial corporates did not face the same existential crisis, and consequently many of the lessons on risk management learnt by the financial sector in recent years have not been absorbed more broadly.

In 2014, the FRC revised the UK Corporate Governance Code to introduce a requirement that UK-listed corporates undertake an assessment of their viability over a period "significantly longer" than 12 months. In corresponding guidance, the FRC explained that a company's board should "think broadly" about the risks facing the company and come to a "reasonable expectation" of viability based on quantitative analysis. In effect, the FRC was beckoning UK-listed corporates to embark down the same trail the financial sector has blazed over the past decade.

[1] Specifically we interviewed banks and insurance companies.

Companies undertook the first disclosures in 2015 annual reports that were released in 2016. In our 17 interviews, we found that the disclosure in the annual report often did not do justice to the underlying exercise; indeed UK-listed companies approached the exercise with varying levels of rigour – and got different things out of it as a result.

A new lens on the business

For financial institutions, the exercise was broadly viewed as a "small increment to what we were doing already". These institutions rely on their other regulatory risk processes (for example, ICAAP[2]) and modelling frameworks to assess their viability. The Viability Statement exercise served as a mere overlay. Despite this, no financial institution found the exercise detrimental or unnecessarily onerous. Therefore we focus on non-financial companies for the remainder of this white paper.

Of the non-financial companies, most find it beneficial to prepare the Viability Statement: nine out of 11 told us the exercise was "useful" while the remaining two were "neutral". The benefits came from three improvements over previous risk processes:

1. The primary impact of the Viability Statement was to raise the quality and sophistication of the internal dialogue on risks. Often this took the form of "bringing together" pieces of work that were already ongoing but had never been discussed in a joined-up way. This suggests an improvement in companies' engagement with the topic of risk; a few even reconsidered their risk appetite through the course of the exercise.

2. For some, the simple quantification of risks allowed a previously theoretical discussion to become more real. A consistent quantitative approach that tied the impact of risk to the financial statements would serve to focus the board discussion with numbers.

3. The exercise also helped companies think through a "toolbox" of mitigations that could be deployed in the event of a severe downside outcome. The CFO of one manufacturing company told us how their board "had a much more measured response to Brexit because we had done the Viability Statement work".

> "The old risk management process was more conceptual. The whole intellectual exercise had more currency this year. Seeing the NPV of our operations after it's been sensitised – what that could really mean – really drove home that message."

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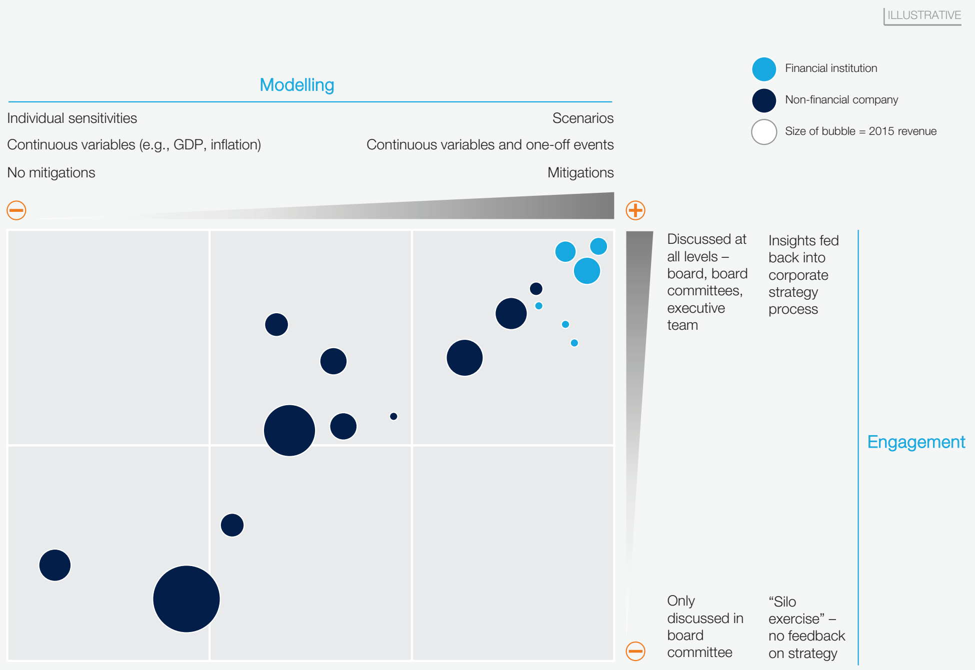
[2] Internal Capital Adequacy Assessment Process.

These benefits were not evenly spread. Companies who are in inherently risky industries – for example, those exposed to commodity prices, major regulatory decisions, natural disasters, geopolitics and/or volatile market conditions – reported that the Viability Statement exercise acted more as a reinforcement of their ongoing work in risk management. The remainder saw considerable improvements in their risk modelling and governance as a result. In fact, a small number of companies encountered a positive surprise of greater financial buffers than previously expected. For these companies, their cash reserves were resilient to many severe but plausible scenarios, which prompted internal discussions about whether they should take on more risk.

The differences in impact stem from the companies' different starting points and the degree to which they increased their sophistication over the course of the exercise. How companies approached the Viability Statement exercise differed primarily in two ways: the sophistication of the modelling approach and the amount of internal engagement on the results of the exercise (Exhibit 1).

Exhibit 1: There was a remarkable range of practices along 2 dimensions: risk modelling and internal engagement



SOURCE: Interviews with UK-listed companies (n=17), McKinsey analysis

1. Modelling uncertain futures

Forecasting the fundamentals of a business and its market is not a simple task. For some non-financial companies, the modelling tools to do so were not in place and had to be built on top of basic existing income statement, balance sheet and cash flow models.

There was also the question of how many years to forecast. Approximately two-thirds of our interviewees assessed viability on a three-year time frame (with the remainder using four- or five-year outlooks). Many expressed that forecasts beyond three years are typically linear extrapolations from more detailed three-year forecasts (and therefore less meaningful). Some commented on how the speed of their business was increasing, with accelerating change in customer behaviours and technological innovation – which would point to a shorter time period considered.

> "How much comfort would I take from directors saying we'll be viable for ten years? It's a naïve statement in my mind. I don't know how you project ten years; five years is a stretch. Credence is exponentially declining from the day after tomorrow."

Across the board, the time period considered matched up with already existing strategic planning processes. No company chose to plan for a longer time horizon than they already did in their strategy planning process. However, most companies we interviewed are willing to make investments in assets whose productive life extends well beyond a three-to-five-year horizon; implicitly, these companies are making a longer-term assessment of risk (and return) in their strategy and capital allocation decisions than is reflected in their Viability Statement.

In our interviews, there were three main areas of difference in modelling approaches:

Individual sensitivities vs. scenarios

While all companies modelled individual risks as sensitivities to their financial outlook, some did not take the further step of coherently clustering risks together into scenarios. Scenarios are more appropriate because they intensify the downside shock without being farfetched, and they can accommodate interaction effects between sensitivities. A common "halfway house" was to test viability against all individual sensitivities simultaneously, the results of which were regularly described as "meaningless". By contrast, some companies – all the financial institutions plus a few non-financial ones – stressed the business against a variety of severe but plausible scenarios. One manufacturer modelled 18 different scenarios, after eliminating many more that they felt did not meet the plausibility criteria.

Continuous variables vs. one-off events

Companies consistently chose to model continuous variables – for example, GDP or inflation – but very few were willing to model one-off events. This was in spite of many companies recognising that one-off catastrophic events would pose a great threat to viability. The resistance to modelling one-off events like a cyberattack or a natural disaster was based on the belief that quantifying it would be extremely difficult or that the organisational response to a major catastrophe would be sufficiently robust to ensure the company's viability.

"We did not try to model events of nature and operational issues. All hands would be to the pump in the organisation anyway to deal with that particular situation given its gravity. The complete random nature of seeking to put in a number – we think that is too difficult."

On the other hand, some companies found ways around the challenge. One IT company used the experience of other companies that suffered a cyberattack to quantify the potential impact on their business. A materials company used the proportionate impact of the 2007-2008 financial crisis on their business to stress their current financial outlook.

Mitigations vs. no mitigations

Some interviewees debated whether the Viability Statement exercise should include modelling management's actions to mitigate the fallout of a downside scenario. Three-fourths modelled mitigations like reducing dividend payouts, cutting capex or other management actions to respond to threats to the company's viability. However, some viewed modelling mitigations on top of the initial scenario or sensitivity as "assumptions on assumptions". One approach we observed elsewhere is to conduct a war game with management, whereby a scenario is presented and debated and any responses are run through the model.

2. An ongoing conversation

The preparation of the Viability Statement was described by one interviewee as a "tick box exercise" that failed to drive a change in behaviours within the business. This sentiment was shared among many interviewees. Outside of financial institutions, the process of assessing longer-term viability is often not joined up in a dynamic way with strategic planning, capital allocation and other business decisions. This has limited the ability of assessing long-term viability to help inform companies' actions.

> "I can't think of anything that has completely changed as a result of this. Though it's a good discipline to get into."

This is reflected in the fact that the Viability Statement was not a major focus for executive teams. Typically, the CFO was responsible for preparing the Viability Statement as part of the year-end accounts, and at a minimum the CEO would have an opportunity to review it. However, only 3 out of 11 non-financial companies held a dedicated discussion with the entire executive team that resulted in insights being included in strategic decision making.

Similarly, many boards delegated the governance of the Viability Statement exercise to the board audit and/or risk committee. Only in a few cases did the entire board engage in a conversation on longer-term viability. Since the Viability Statement was seen by some as a "glorified going concern statement", many boards held to governance processes that were already in place.

In a few cases where internal engagement was comprehensive, the exercise provoked a systematic review of the company's risk profile, risk management approach and the strategic posture of the company. One retailer held workshops with their executive team to reconsider their risk register and define plausible downside scenarios; the board audit committee of the same company spent significant time discussing the appropriate modelling methodology to arrive at robust and meaningful results.

> "We took a more deep-rooted review of uncertainties, identifying cybersecurity as more important than in the past. We combined some risks. I suspect there are a couple of risks that we've thought a bit harder about how they would impact us."

There was also broad recognition of the value of a more structured, analysis-enriched conversation with key decision makers about risks, and many companies were keen to improve on their approach going forward. As the lessons from the Viability Statement exercise are embedded and companies' approaches evolve, the intent is summed up by one interviewee as, "you start with the risk process and it develops and becomes richer in time."

Stress-testing strategy

UK-listed non-financial corporates have taken a first step towards a more nuanced and insightful appreciation of their risk exposures and how that links to their strategic postures. As the viability assessment processes put in place last year mature, the feedback loops into major business decisions should deepen as well. The kinds of strategic questions that the Viability Statement exercise can help inform are fundamental to the effective stewardship of a company, for example:

- For companies with greater resilience than otherwise expected, could they take on more risk? Are they inefficiently holding onto excess cash that should be invested or returned to shareholders? Or are they downplaying the real threats to viability and should test against more challenging circumstances?

- For companies whose viability is more fragile than otherwise expected what decisions being taken now are locking in a suboptimal balance between risk and expected return? And what plans need to be put in place now to prepare for the worst?

In terms of the Viability Statement exercise itself, there remains a lack of clarity among companies of what "good" or "advanced" practice looks like. Based on these early conversations and our other research into risk management[3], we identify three elements of an "advanced practice" approach to the Viability Statement:

1. Modelling stress scenarios (instead of sensitivities), one-off events and mitigations

2. Establishing a governance process through both the executive team and the board (and its relevant committees), including regular feedback loops into the strategic planning and capital allocation processes

3. Ensuring a comprehensive disclosure in the annual report of a company's risk identification framework, rationale for time period considered, modelling approach and governance process.

These practices would go some way towards fulfilling the spirit, more than just the letter, of the Viability Statement requirement. More importantly, these practices would also help companies take a more integrated view of strategy, risk and return.

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The introduction of the Viability Statement reflects the FRC's focus on continuously innovating the financial disclosure that underpins investor confidence. For many companies, preparing the Viability Statement resulted in improved analysis and discussions of risk. As the practice of preparing the Viability Statement matures, there is a real opportunity for companies to ensure that the process is more meaningful than simply a "tick box exercise".

[3] Abhishek Anand, Cindy Levy, Ernestos Panayiotou and Aleksander Petrov, "Navigating stormy waters: a stress-testing framework for non-financial corporates," McKinsey Risk Practice, November 2016.

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