

Tackling the viability statement

Practical suggestions,
positive thinking

February 2016



An aerial, high-angle photograph of a city street paved with grey rectangular stones. Several square manholes with decorative covers are visible. Pedestrians are walking across the street: a man in a light blue shirt and dark trousers in the top left; a group of three men in dark suits walking towards the center; a woman in a pink top and black pants walking towards the right; and two men in dark suits walking away from the camera in the bottom right. Long, soft shadows are cast across the pavement, suggesting a low sun position.

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Introduction

Although discussions around the viability statement have tended to focus on what period to choose, we have always believed that much of the value of the new Code provision will be in the disclosures that it generates (see below for a reminder of the requirements). Our experience of spending the last year or more helping many companies and boards with both their internal processes and external disclosures – and of talking to investors about what they want from the new requirements – has only reinforced this view. With three to five years emerging as the default choice for the period, almost always based on the business plan, it's the disclosures that will allow companies to differentiate themselves and to make the assessment of prospects and viability an integral part of telling their overall story.

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. [UK Corporate Governance Code > Provision C.2.2]

We therefore thought that the time was right to make some practical suggestions about how to tackle the disclosures, based on our experience so far. We have done this by providing an illustrative draft statement, along with commentary explaining the key aspects of our proposals. Our draft is not, of course, meant to be a template or checklist but we hope that, along with the commentary, it will help companies and boards to develop statements that are compliant, tailored to their own circumstances and that provide some real insight into risks to solvency and liquidity and how they are managed.

The following observations have emerged from our work with companies and influenced the thinking behind the draft statement:

- **Companies have always assessed their prospects.** The need for a new formal statement over a defined period shouldn't sweep aside what management teams and boards already do to sustain and develop their businesses. The existing business planning and risk management processes may not be perfect but, driven by the business model and strategy, they should be at the heart of the assessment process and disclosure.
- **It's not all about the process.** A disclosure that focuses only on process is, at best, a missed opportunity. Management teams and boards make a whole range of judgements and assumptions in arriving at their business plans and putting risk management processes in place. The new Code encourages the same to happen around testing the company's resilience to events that are not in the plan. A really valuable disclosure will provide insight into these judgements, within the bounds of commercial sensitivity.

Along with our commentary we have included a number of extracts from published annual reports where companies have made disclosures of the kind we're suggesting – our experience in recent times is that there has been a shift in the mindset of many management teams and boards, and some of the latest published reports support this. Although there may still be an element of natural conservatism in year one of the new disclosures, we are seeing an encouraging trend away from the minimalist, compliance-driven approach that at one stage characterised the debate around the viability statement. We hope that this paper will help to encourage that trend.

We start overleaf with our illustrative draft statement in full and in the pages that follow we break the statement down and comment on it.

Illustrative draft statement

1) Assessment of prospects

The context for the assessment (of prospects)

The group's business model and strategy are central to an understanding of its prospects, and details can be found on pages [x] to [y]. The nature of the group's activities is long-term and the business model is open-ended. The group's current overall strategy has been in place for several years, subject to the ongoing monitoring and development described below. The core business of the group has a [12]% share of its market globally and the related segment has reported an average of £[x]m of EBITDA over the past [10] years.

The board continues to take a conservative approach to the group's strategy in the core business and the focus is largely on cost control and centralisation. Decisions relating to major new projects and investments are made with a low appetite for risk and are subject to an escalating system of approvals, including short payback periods. Similar controls operate in relation to major new customer contracts.

The group's focus is particularly on developing the [ABC] business unit, because of the substantial opportunities in the [digital/US] market. The board has considered the changes in the risk profile of the group that this entails and determined that they are acceptable in the context of the risk profile of the group as a whole: the expected longer term returns mean that there is more appetite for risk, for instance in the form of product development for a market to which the group is relatively new.

The assessment process and key assumptions

The group's prospects are assessed primarily through its strategic planning process. This process includes an annual review of the ongoing plan, led by [the CEO through the management committee] and all relevant functions are involved, including [product and market development, finance, treasury and risk]. The board participates fully in the annual process by means in particular of [annual strategic away-days.] Part of the board's role is to consider whether the plan continues to take appropriate account of the external environment including [macroeconomic, political, social, technological] changes.

The output of the annual review process is [a set of objectives, an analysis of the risks that could prevent the plan being delivered, and a number of financial forecasts]. The latest updates to the strategic plan were finalised in [month] following this year's review. This considered the group's current position and the development of the business as a whole over the next [20] years, focusing on the prospects for the [ABC] business unit in the next [5] years based on the initiatives in the [digital/US] market.

As a result of this focus, detailed financial forecasts were also prepared for the [5] year period to [date], so that [years/months] remains at the time of approval of this year's annual report. The first year of the financial forecasts form the group's operating budget and is subject to a re-forecast process at the half-year. The second year is in a similar level of detail, and is flexed based on the actual results in year one. Years three to five of the forecasts are extrapolated from the first two years, based on the overall content of the strategic plan.

The key assumptions in the financial forecasts, reflecting the overall strategy, include:

- [Significant]/[10%] annual growth in the [ABC] business unit from [year] to [year]
- A [significant]/[5%] saving on certain administrative costs for the group as a whole as a result of the ongoing restructuring of the back-office functions as part of the centralisation programme

It has also been assumed that refinancing will be available on similar terms to those negotiated in [year] to support the expansion of the [ABC] business unit.

These key assumptions are reflected in numbers [1, 2 & 3] of the group's principal risks, which are set out on pages [x] to [y]. The purpose of the principal risks [table] is primarily to summarise those matters that could prevent the group from delivering on its strategy. A number of other aspects of the principal risks – because of their nature or potential impact – could also threaten the group's ability to continue in business in its current form if they were to occur. This was considered as part of the assessment of the group's viability, as explained below.

2) Assessment of viability

Although the strategic plan reflects the directors' best estimate of the future prospects of the business, they have also tested the potential impact on the group of a number of scenarios over and above those included in the plan, by quantifying their financial impact and overlaying this on the detailed financial forecasts in the plan. These scenarios, which are based on aspects of principal risks [3, 4 & 5], represent 'severe but plausible' circumstances that the group could experience.

The scenarios tested included:

- A serious breach of regulatory requirements in the [US/digital] market as a result of enhanced regulator focus and lack of experience within the group, leading to fines and a loss of reputation among potential customers
- A [significant]/[20%] shortfall in EBITDA in the [ABC] business unit, leading to covenant breaches and/or downgraded credit rating (and the knock-on effect on the cost of future capital to fund expansion)

The results of this stress testing showed that, due to the stability of the core business, the group would be able to withstand the impact of these scenarios occurring over the period of the financial forecasts by making adjustments to its operating plans within the normal course of business.

The group also considered a number of scenarios that would represent serious threats to its liquidity. None of these was considered to be plausible.

3) Viability statement

Based on their assessment of prospects and viability above, the directors confirm that they have a reasonable expectation that the group will be able to continue in operation and meet its liabilities as they fall due over the five year period ending [date].

4) Going concern

The directors also considered it appropriate to prepare the financial statements on the going concern basis, as explained in the Basis of preparation paragraph in note 1 to the accounts.

Commentary on illustrative draft statement

Illustrative disclosures

1) Assessment of prospects

Commentary

We have suggested splitting the assessment of ‘prospects’ from the assessment of ‘viability’ (see page 12 onwards). We think this would allow companies to provide broader and deeper insight into the future of the business separately from the need to support the formal viability statement.

The wording of the Code provision that gives rise to the viability statement also makes a distinction between the assessment of prospects and the ability to make the formal statement – directors assess prospects first and then decide whether they have a ‘reasonable expectation’ that the company will be able to meet its liabilities as they fall due over the period of the assessment.

The context for the assessment (of prospects)

The group’s business model and strategy are central to an understanding of its prospects, and details can be found on pages [x] to [y].

The nature of the group’s activities is long-term and the business model is open-ended. The group’s current overall strategy has been in place for several years, subject to the ongoing monitoring and development described below.

The core business of the group has a [12]% share of its market globally and the related segment has reported an average of £[x]m of EBITDA over the past [10] years.

Commentary

The prospects for any group are intrinsically linked to its business model and strategy and to its track record, so it makes sense to explain how these have affected the directors’ assessment in the specific circumstances. Without creating a hostage to fortune, we think it should be easy to tell whether the directors believe that there is any question about the group’s ‘viability’ over the period chosen for the formal statement, and this is an opportunity to set the appropriate tone.

See example 1 opposite from Grainger plc

Example 1 – Grainger plc

September 2015 annual report > page 29

The Group's business model has proven to be strong and defensive in the long term and it has consistently demonstrated its ability to sell assets, even in challenging market conditions. From 2006 to 2015 the gross cash generation has never been less than £240m per annum and has averaged c.£296m with a peak of £430m. Currently the Group directly owns £2.2bn of residential property assets which are relatively liquid, as has been proved in the past. The Group would remain viable even in the event of very severe and sustained house price deflation as it would be able to accelerate the natural conversion of our assets to cash and suspend acquisition activity. Only an unprecedented and long-term lack of liquidity in UK residential property markets would cause any threat to the Group.

Illustrative disclosures

The board continues to take a conservative approach to the group's strategy in the core business and the focus is largely on cost control and centralisation. Decisions relating to major new projects and investments are made with a low appetite for risk and are subject to an escalating system of approvals, including short payback periods. Similar controls operate in relation to major new customer contracts.

The group's focus is particularly on developing the [ABC] business unit, because of the substantial opportunities in the [digital/US] market. The board has considered the changes in the risk profile of the group that this entails and determined that they are acceptable in the context of the risk profile of the group as a whole: the expected longer term returns mean that there is more appetite for risk, for instance in the form of product development for a market to which the group is relatively new.

Commentary

Strategic decisions are taken in the context of the board's appetite for risk, so there is a direct link between high level risk appetite and the assessment of prospects.

Risks other than strategic risks could also have a significant impact on performance and, ultimately, viability – particularly where they might have a knock-on effect on reputation or 'licence to operate'. The board's appetite for these would also be relevant to the assessment, therefore, and could be considered for disclosure.

Commentary on illustrative draft statement (Contd.)

Illustrative disclosures

The assessment process and key assumptions

The group's prospects are assessed primarily through its strategic planning process. This process includes an annual review of the ongoing plan, led by [the CEO through the management committee] and all relevant functions are involved, including [product and market development, finance, treasury and risk]. The board participates fully in the annual process by means in particular of [annual strategic away-days.] Part of the board's role is to consider whether the plan continues to take appropriate account of the external environment including [macroeconomic, political, social, technological] changes.

The output of the annual review process is [a set of objectives, an analysis of the risks that could prevent the plan being delivered, and a number of financial forecasts].

Commentary

This starts to address the requirement to discuss **how** the prospects have been assessed.

The integration of risk management, strategy and business model and business planning is specifically highlighted by the FRC as part of an effective system of risk management and internal control in its Guidance issued alongside the 2014 Code (the *Guidance on Risk Management, Internal Control and Related Financial and Business Reporting*).

Illustrative disclosures

The latest updates to the strategic plan were finalised in [month] following this year's review. This considered the group's current position and the development of the business as a whole over the next [20] years, focusing on the prospects for the [ABC] business unit in the next [5] years based on the initiatives in the [digital/US] market.

Commentary

Because the broader prospects are being assessed first, there is an opportunity to confirm that the future of the business has been considered in the very long term. This could be relevant in particular in industries which have long-term assets or contracts, including extractive businesses and life insurance/pension providers.

Illustrative disclosures

As a result of this focus, detailed financial forecasts were also prepared for the [5] year period to [date], so that [years/ months] remain at the time of approval of this year's annual report. The first year of the financial forecasts form the group's operating budget and is subject to a re-forecast process at the half-year. The second year is in a similar level of detail, and is flexed based on the actual results in year one. Years three to five of the forecasts are extrapolated from the first two years, based on the overall content of the strategic plan.

Commentary

We now begin to focus the assessment on the business unit with the particular growth initiatives, as the first step towards explaining why the period chosen for the viability statement is appropriate. In our scenario, the detailed planning horizon is five years because the prospects for business unit [ABC] are fundamental to the assessment for the group as a whole. In other cases there may be specific characteristics of the business or industry that suggest a particular choice of period.

See example 2 below from Derwent London plc

If we roll our scenario on 12 months it may be that the group will have rolled forward its five-year plan for business unit [ABC]. Alternatively, there could be a coherent argument for moving to a four-year assessment, or another factor may have superseded the prospects for business unit [ABC] as the driver of the overall group assessment.

Two other comments on this part of the disclosure:

- We've provided more detail here on the way the forecasts are drawn up, reflecting the higher degree of confidence that will usually apply to the earlier periods – this is something that the FRC specifically recognises in its Guidance issued with the Code.
- We've also been very clear about the time left on the latest strategic plan as at the date the annual report is approved. Where the period chosen for the viability statement is relatively short, this could be significant.

Example 2 – Derwent London plc

December 2014 annual report > page 27

Viability statement

In accordance with provision C.2.2 of the 2014 revision of the Code, the Directors have assessed the prospect of the Company over a longer period than the 12 months required by the 'Going Concern' provision. The Board conducted this review for a period of five years, which was selected for the following reasons:

- i) The Group's strategic review covers a five-year period.
- ii) For a major scheme five years is a reasonable approximation of the maximum time taken from obtaining planning permission to letting the property.
- iii) Most leases contain a five-year rent review pattern and therefore five years allows for the forecasts to include the reversion arising from those reviews.

The five-year strategic review considers the Group's cash flows, dividend cover, REIT compliance and other key financial ratios over the period.

Commentary on illustrative draft statement (Contd.)

Illustrative disclosures

The key assumptions in the financial forecasts, reflecting the overall strategy, include:

- [Significant]/[10%] annual growth in the [ABC] business unit from [year] to [year]
- A [significant]/[5%] saving on certain administrative costs for the group as a whole as a result of the ongoing restructuring of the back-office functions as part of the centralisation programme

It has also been assumed that refinancing of the group's long-term debt will be available on similar terms to those negotiated in [year] to support the expansion of the [ABC] business unit.

Commentary

The Code encourages directors to draw attention to any 'qualifications or assumptions' as necessary, language that has been carried across from the previous version of the going concern provision.

There is a natural tendency to think of assumptions in connection with stress testing. In fact, we think that most of the significant assumptions underlying the assessments of prospects and viability will be included in the strategic plan – hence we have pulled out some underlying assumptions from the plan in our illustrative disclosure.

See example 3 opposite from Shaftesbury plc



In our view, qualifications will be rare but there will almost always be assumptions. There's an important difference in the two terms: to us, a qualification means that the company will not be viable **unless** something happens or is the case, whereas an assumption means that the company will be viable **providing** something happens or is the case.

In our scenario, there is an assumption in the plan about the ability to refinance and this has been disclosed – because of its size – as important to the assessment of the group's prospects. There is no suggestion that the directors see this as being difficult when the time comes. In other circumstances, the need to refinance could be a material uncertainty for going concern purposes – in other words, a qualification. In both cases, however, the issue will have been reflected in the business plan, hence the importance we are placing on the plan in our draft disclosures.



Example 3 – Shaftesbury plc

September 2015 annual report > page 66

<p>The Board conducted the review for a five-year period, corresponding with the period covered by its current forecasts. These forecasts are updated quarterly and reflect the Group's established strategy of investing in London's West End, its existing investment commitments, available financial resources and long-term financing arrangements. They consider profits, cash flows, funding requirements and other key financial ratios over the period, as well as the headroom in the financial covenants contained in our various loan agreements. Important assumptions underlying the forecasts include:</p>	
Assumption	Comment
Crystallisation of the portfolio reversionary potential over the period	<p>We have a long record of crystallising the independently-assessed ERV of our portfolio over a three-to-five year period. 63% of the total portfolio reversion comes from shops, restaurants, cafés and pubs, the demand for which, in our locations, is not cyclical and has demonstrated sustained growth over many years.</p> <p> SEE DETAILS ON THE REVERSION ON PAGE 40</p>
The Group had undrawn committed loan facilities at 30 September 2015 totalling £150.3 million, which comfortably exceeds the Group's commitments over the assessment period. This assumes an ability to re-finance revolving credit facilities totalling £150.0 million and £125.0 million which mature in 2018 and 2020 respectively.	<p>The Group maintains a prudent approach to gearing, with debt facilities which are largely fixed and long-term in nature. At 30 September, our loan-to-value ratio was 22.5%.</p> <p>The facilities which mature during the period of assessment represent 18.8% and 15.7%, respectively, of our total committed debt facilities.</p> <p>The Board has reasonable confidence that we shall be able to refinance these facilities and intends to do so in advance of their contractual maturities.</p> <p> SEE THE FINANCE REVIEW ON PAGE 56</p>

Commentary on illustrative draft statement (Contd.)

Illustrative disclosures

These key assumptions are reflected in numbers [1, 2 & 3] of the group's principal risks, which are set out on pages [x] to [y]. The purpose of the principal risks [table] is primarily to summarise those matters that could prevent the group from delivering on its strategy.

A number of other aspects of the principal risks – because of their nature or potential impact – could also threaten the group's ability to continue in business in its current form if they were to occur. This was considered as part of the assessment of the group's viability, as explained below.

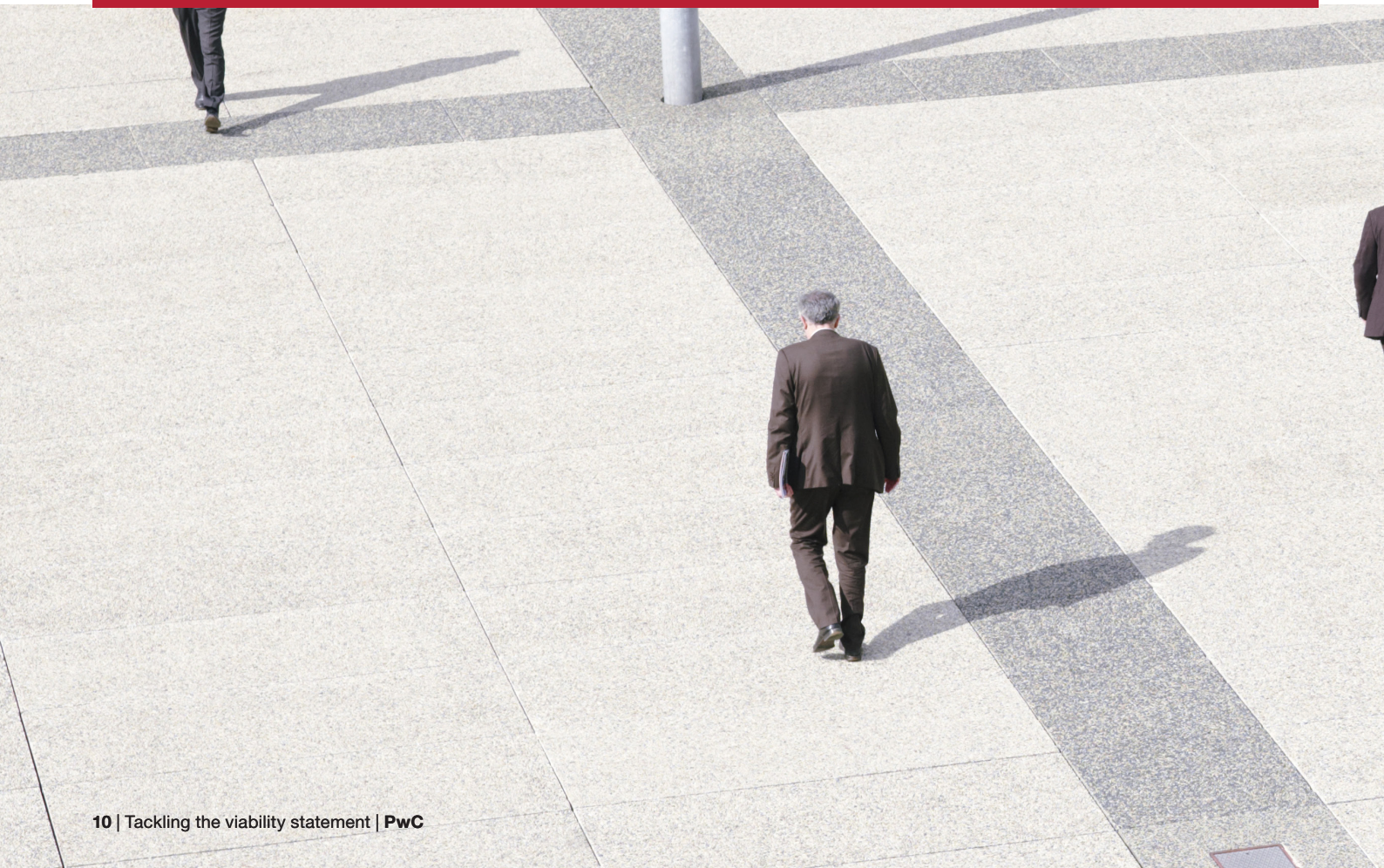
Commentary

The Code requires the directors to take account of the principal risks so it is important to be clear on how this has been done.

We have emphasised the distinction between those principal risks that would most likely only affect performance and those that could threaten the existence of the group. The former are important to an assessment of prospects, but it's the latter group that must be considered for the viability assessment.

See example 4 opposite from Lonmin plc

We note that some companies are choosing to make the new statement required under provision C.2.1 of the Code confirming that the directors have carried out a robust assessment of the principal risks in conjunction with the assessment of prospects and viability. This can help to emphasise the relationship between the two, though the robust assessment will often cover risks that are not directly relevant to a company's viability.



Example 4 – Lonmin plc

September 2015 annual report > page 32

For the purposes of assessing the Group's viability, the directors focused their precise attention on the following principal risks which are critical to the Group's success:

- ***Inadequate liquidity levels***
The declining PGM price environment has put the Group's ability to generate cash under significant pressure. Furthermore, the Group's existing US Dollar and Rand debt facilities mature in May and June 2016 respectively.
- ***Failure to deliver the required operational performance***
Failure to deliver against production and cost targets due to a variety of reasons which include poor productivity, safety stoppages, industrial action and difficult geological conditions.
- ***Metal prices and currency volatility***
Factors exist which are outside the control of management which can have a significant impact on the business, specifically, volatility in the Rand / US Dollar exchange rate and PGM commodity prices.



Commentary on illustrative draft statement (Contd.)

Illustrative disclosures

2) Assessment of viability

Although the strategic plan reflects the directors' best estimate of the future prospects of the business, they have also tested the potential impact on the group of a number of scenarios over and above those included in the plan, by quantifying their financial impact and overlaying this on the detailed financial forecasts in the plan. These scenarios, which are based on aspects of principal risks [3, 4 & 5], represent 'severe but plausible' circumstances that the group could experience.

Commentary

Moving on to the narrower question of 'viability' (as opposed to 'prospects'), the FRC Guidance issued with the Code suggests that stress testing will often help to support the directors in making their formal statement, and we are finding that the majority of companies (including those outside the financial services sector) are indeed carrying out stress testing, at least to some extent. As noted above, the strategic or business plan is the baseline against which any stresses are run.

We have assumed here that the directors will develop scenarios to test, rather than test the principal risks themselves. Testing the risks themselves would have the advantage of avoiding the need to link between them and the scenarios in the way that we have illustrated, but many boards find that scenarios allow a more realistic assessment exercise to be carried out. The use of scenarios can, in particular, help boards to think about how risks correlate, combine or trigger each other.

Note that principal risk 3 was referred to as part of an assumption included in the plan and has also been referred to here as part of a stress test. This is intended to reflect situations where the **expected** impact of a risk is factored into the plan but a more severe impact is stress tested.

Illustrative disclosures

The scenarios tested included:

- A serious breach of regulatory requirements in the [US/digital] market as a result of enhanced regulator focus and lack of experience within the group, leading to fines and a loss of reputation among potential customers
- A [significant]/[20%] shortfall in EBITDA in the [ABC] business unit, leading to covenant breaches and/or downgraded credit rating (and the knock-on effect on the cost of future capital to fund expansion).

Commentary

We have seen a range of approaches to the disclosure of stress tests, from a simple confirmation that they have been done, through to more detailed descriptions. Some companies even quantify the parameters for the tests – in the terms of our illustration this would mean disclosing that they have modelled a 20% shortfall in EBITDA rather than simply a 'shortfall' or a 'significant shortfall'.

See example 5 opposite, again from Grainger plc

We would advocate at least disclosing the nature of the tests.

Example 5 – Grainger plc

September 2015 annual report > page 29

The budget has been stress tested against severe and prolonged reductions in house prices. Two different scenarios were modelled to stress-test the business model. First an aggressive but short-term house price crash with a slow return to growth thereafter and secondly a continuing slow decline in house prices. The testing incorporated the use of mitigating actions available to the business, such as a reduction in acquisition spend and accelerated sales.

The first scenario modelled a short term crash, greater in both severity and duration than the correction experienced in 2008 – 9. The valuation assumptions used in this analysis were for two full years (8 quarters) of decreasing prices, with year on year falls of 15% p.a. – a total decline of c.27.5%. There then follows one subsequent year where 0% growth is forecast and one further year at 5% annual growth. The second scenario modelled a long term decline in house prices of 2.0% p.a. over the life of the model with no recovery.



Commentary on illustrative draft statement (Contd.)

Illustrative disclosures

The results of this stress testing showed that, due to the stability of the core business, the group would be able to withstand the impact of these scenarios occurring over the period of the financial forecasts by making adjustments to its operating plans within the normal course of business.

Commentary

Because the group in our scenario was able to withstand the stress tests, no discussion of potential remedial management action (such as asset sales or dividend cuts) has been included.

Where such actions would be needed to withstand the tests we would certainly encourage disclosure of the nature of the actions (though we expect it would be rare to see the extent of the necessary actions being specified). We would also re-emphasise how the tests go beyond the expected outcomes that are reflected in the strategic or business plan.

Illustrative disclosures

The group also considered a number of scenarios that would represent serious threats to its liquidity. None of these was considered to be plausible.

Commentary

It is also possible to start from a scenario that would 'break the business model' within the relevant period and consider whether it is within the 'severe but plausible' criteria. This technique is referred to as 'reverse stress testing' and the FRC encourages it in the Guidance issued with the Code.

Reverse stress testing is most associated with the financial services sector, but we think that the disclosure we have suggested here would convey a powerful message in many circumstances.

Illustrative disclosures

3) Viability statement

Based on their assessment of prospects and viability above, the directors confirm that they have a reasonable expectation that the group will be able to continue in operation and meet its liabilities as they fall due over the five year period ending [date].

Commentary

We think that the wording of the formal statement should mirror the relevant Code provision as closely as possible, and all those issued so far have done so.

Because of the explanations above, we would not in this case provide any further commentary on why five years was the appropriate period for the directors to choose.

Illustrative disclosures

4) Going concern

The directors also considered it appropriate to prepare the financial statements on the going concern basis, as explained in the Basis of preparation paragraph in note 1 to the accounts.

Commentary

We do not recommend including a statement on going concern in the ‘front half’ of the annual report because Code provision C.1.3 now relates simply to the accounting purpose of going concern. However some companies are continuing to do so and, even where the main disclosure is in the financial statements, boards may feel more comfortable with at least a cross-reference of this kind to the relevant financial statement note.

Separate discussions of viability and going concern in the front half need to be carefully coordinated to avoid confusion and we would in particular avoid reference to ‘the foreseeable future’ in connection with the going concern confirmation now that the directors specify the period over which the group’s prospects have been assessed for the purposes of the viability statement.

Contacts

We would very much like to hear your views on our suggestions. To discuss them or any other area of compliance with the 2014 UK Corporate Governance Code, please get in touch with your usual PwC contact or one of the central team listed below.



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For more on how to implement the risk, viability and going concern aspects of the 2014 UK Corporate Governance Code, visit our [website](#)

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