COVID-19

Reporting on the impact of COVID-19

Q&As and practical guidance

May 2020

Introduction and scope

This guidance sets out information, based around Q&As, about how the COVID-19 crisis affects various aspects of corporate reporting. It takes into account guidance from the Financial Reporting Council ('FRC'), the European Securities and Markets Authority ('ESMA'), various investor groups (including the Investment Association and ISS) as well as our own comments and recommendations.

There are four sections, focusing on the impact of COVID-19 on the reporting of:

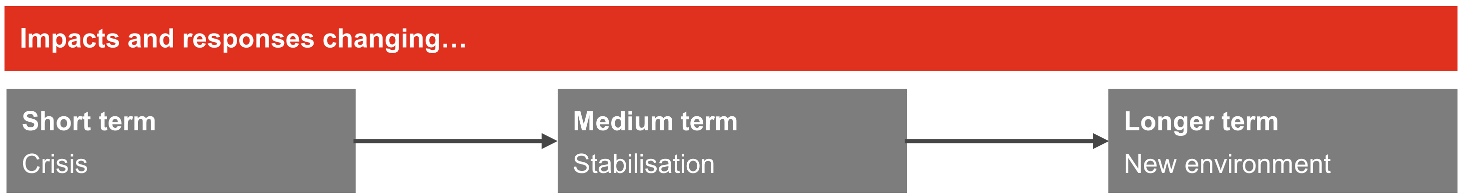
- Going concern and viability
- Governance, risk and internal control
- Balancing the interests of shareholders and other stakeholders
- The impact on a company's financial results.

Key themes

Two key themes run through the guidance:

1. The impact of the crisis varies from company to company and this guidance therefore reflects the significance of a company's **business and industry** for its reporting. There will be few that are completely untouched by COVID-19, given its global economic impact, and any company reporting very limited effects will need to explain carefully the basis for its conclusions
2. The **timeline** of the crisis also has major implications. For many companies their priorities, and therefore the content of their reporting, will change as the situation develops. Initially the focus has often been on explaining how immediate concerns about liquidity have been tackled (something which we particularly focused on in this earlier publication), but this will move on to how the business is being operated through the crisis to safeguard its ongoing sustainability and, ultimately, how it is adapting to the changed business and economic environment.

Figure 1: The progression of the crisis



Introduction and scope (cont'd)

Good reporting is good reporting...

Although it throws up new challenges, good reporting on the impact of COVID-19 will follow the same principles that apply to good reporting generally (including those reflected in the FRC's Guidance on the strategic report). It should be **company-specific** and **forward-looking**, and it should make the relevant **connections** between related pieces of information for the reader. Duplication of content should rarely be needed – it is much better to tell the story once and use cross-references and links to meet any other technical requirements.

Reporting on the impact of COVID-19 should also follow the principle that applies to the annual report as a whole by being **fair, balanced and understandable**. Our initial sense from reporting so far is that the understandability factor is proving to be a challenge, with particular issues being highlighted without a clear context or conclusion in many cases. Fairness and balance will become particularly important as companies start to try and identify the impact of COVID-19 on their position and performance.

Part of the issue in the early stages of the crisis has been **consistency**. Many reports that were almost ready to be released have had to have a COVID-19 'overlay' added to deal with issues as they emerge. It's very important that such an overlay is not done without reconsidering the text of the report as a whole.

A new reporting context

We do not underestimate the challenges that many companies face currently, and reporting can seem low down the list of priorities in the circumstances. Some of the information involved in reporting on the crisis will no doubt also feel particularly sensitive – maybe too commercially sensitive to disclose. That could be one reason why some of the early disclosures are less informative than they might be. Equally, there is a strong argument that the current circumstances actually increase the need for transparency and openness, and investors have already been calling for this to allow them to support companies through the crisis.

We hope that this guidance helps companies to identify and deal with the challenges that are most relevant for them so that they are able to build the trust and confidence of their shareholders and other stakeholders through the quality of their reporting in these unprecedented circumstances. We will keep the guidance updated as reports continue to emerge.

Executive summary

The key messages in each of the four sections of our guide are summarised below:

Section 1: Going concern and viability

Particularly in the early stages of the crisis, good disclosures around liquidity and solvency will be the first priority, including how the nature of the business and its financial structure and position affect them.

In its latest guidance the FRC states that it expects more disclosures of material uncertainties for going concern. Reporting on going concern should now include COVID-19-related stress and scenario testing, as should the viability statement. In both cases the disclosures should set out enough information to understand the parameters used in the stress or scenario testing and what the results showed. Where the audit committee takes the lead on behalf of the board the audit committee report should reflect this.

The period covered by the viability statement crosses over with that of the going concern confirmation in the earlier years and the two must be consistent, including in the treatment of any material uncertainties. Matters that are not regarded as material uncertainties mainly because of their timing will also be relevant to the viability statement. It is crucial for viability statements to be clear about the assumptions on which they are made, particularly at the present time. The longer-term aspects of the statements might be less critical in the early stages of reporting on the crisis but will move back into the spotlight as it develops.

Good disclosure of the relevant judgements will equally be required when companies do not believe they will be substantially affected by the crisis.

Section 2: Governance, risk and internal control

COVID-19 will generally need to be reflected in principal risk disclosures. Companies should consider both the impact on the overall resilience plan for the business and how the crisis affects specific principal and emerging risks.

There is likely to be more pressure to disclose 'black swan' risks in future as a result of COVID-19. Relatively few companies have historically included anything relevant in their principal risk disclosures.

It is important to show how the company's governance and systems of risk management and internal control have been adapted to take account of the crisis (including the effects of social distancing and the increased use of technology), and that the right quality of information is still available for decision making.

Executive summary (cont'd)

Section 3: Balancing the interests of shareholders and other stakeholders

Much of the new reporting on section 172 and stakeholder engagement, as well as the areas of increased emphasis in the 2018 UK Corporate Governance Code, are highly relevant for reporting on the impact of COVID-19. Good reporting will explain the balance that has been struck, and why, in decisions including:

- Whether or not to pay dividends (or return capital in other ways)
- Whether and how to raise more capital or other forms of finance
- The treatment of employees and the wider workforce (including changes to pay and conditions)
- Executive pay (including bonus entitlements and long-term incentive schemes)
- The treatment of customers and suppliers
- The use of the various forms of government support that are potentially available
- Other capital allocation decisions including whether to cancel or scale back capital expenditure, research and development and so on.

The long-term consequences of such decisions are even more significant where boards are working to balance the short-term survival of the organisation with its long-term goals and stated purpose, culture and values. The experience of the crisis will also inform the debate on the purpose of business going forward.

Investor groups have drawn attention to the need for these decisions to be properly arrived at and explained – and for the right balance to be struck.

Decisions on dividend policy in the light of the crisis need to consider not only the question of balance but the difficulties of forecasting in the current situation.

Changes are being made by many companies to the pay of executives to reflect the crisis, including discretionary adjustments to salary and bonuses. The relationship between executive pay and the treatment of the rest of the workforce is particularly sensitive. The Investment Association has issued guidance on its members' expectations in this area.

Executive summary (cont'd)

Section 4: The impact on a company's financial results

Results reported for financial years ended up to March 2020 will generally not be materially affected by the crisis, other than some significant impairment charges, and disclosures will focus on the strength of the balance sheet and the assessment of future impacts.

Reports after this date might highlight the effect of COVID-19 through alternative performance measures ('APMs'). Companies will also want to track the effects of the crisis in internal management information, which could lead to new key performance indicators.

ESMA has issued a specific Q&A on applying its Guidelines on the use of APMs to COVID-19, pointing out that the use of new APMs is unlikely to be appropriate where the effect of the crisis on the reported results is pervasive. Companies should focus on good narrative disclosures in these circumstances.

1

Going concern and viability

A. Liquidity, going concern and material uncertainties

Many companies are continuing to deal urgently with the immediate challenges of the crisis for their liquidity and solvency as well as looking ahead to the ongoing risks and uncertainties (see Section 2 > Governance, risk and internal control below). The impact of these challenges and uncertainties is the key reporting priority connected with the crisis, bearing in mind that they will vary from case to case and over time as the crisis develops.

The FRC has issued guidance on reporting, which states that more 'material uncertainties' are likely to be disclosed by companies. The Q&As below reflect this guidance, including the procedural and reporting recommendations. For more information on the impact of the crisis on financial statements and notes see PwC's publication on accounting implications.

> 'Material uncertainty' 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.'
>
> [FRC Company Guidance Update March 2020 (COVID-19)]

The audit committee tends to take the lead in considering both going concern and viability for the board. It will be particularly important to demonstrate in audit committee reports that this has been done in the current circumstances, including the new areas of emphasis discussed below.

Q1: What are the key factors to address in these disclosures?

A: There are two factors that characterise the more successful disclosures of the impact of the crisis on liquidity and solvency (and therefore on going concern):

- They explain the relevance of the **nature of the business** well
- They are clear about its **financial structure and position**.

These factors are key to the understandability of the report and reflect the top priorities expressed by investors for information on how the immediate crisis is being addressed.

It's important to bear in mind that businesses might be affected differently as the crisis develops and that all will be affected to some degree. Short-term opportunities for a business might also turn to risks in the longer term, and vice versa.

A. Liquidity, going concern and material uncertainties (cont'd)

Q2: What aspects of the nature of the business are likely to be most relevant?

A: By definition, there is no one-size-fits-all answer to this. But matters that are likely to be relevant include, for example:

- The countries that the business operates in (and their response to the crisis, including the availability of government support)
- The nature of the company's goods and services (including how practical it is to keep producing these, and the nature of the supply chain and distribution channels)
- The nature of the company's workforce (and whether they can work remotely, where required).

These matters will of course have direct and indirect effects on a company's financial performance, through their impact on:

- Its ability to continue to generate revenue at the usual levels, or at all
- The split of its cost base between fixed and variable costs.

Depending on their relevance in the particular circumstances these could all be important areas to report on. They can be equally important whether a company is explaining that it has significant issues or justifying the directors' judgement that it has not.

Q3: What aspects of a company's financial structure and position are the most important to address?

A: Cash, in the current situation, remains king and investors are particularly focused on understanding a company's cash holdings (including any restrictions on these, such as on cash held in other territories), and its existing facilities. Note that although undrawn facilities may currently be regarded as fully and immediately available, this could change as the crisis develops – any significant assumptions would need to be disclosed. The same applies to the use of invoice discounting or factoring schemes.

Liquidity will be the most immediate concern in some cases but in many others covenants will become an issue first. Good reporters have historically been clear on the nature of their covenants and the headroom that exists against them, and this is likely to become critical in the current circumstances. Although the PRA has stated its expectation that 'banks will treat covenant breaches that arise from COVID-19 related matters that are of a general nature or are firm-specific but unrelated to the solvency or liquidity of the borrower differently compared to uncertainties that arise because of borrower-specific issues and in doing so consider waiving the resultant covenant breach', a company's position in this regard will still be very important to address.

A. Liquidity, going concern and material uncertainties (cont'd)

In certain circumstances (such as where there is significant uncertainty) it might also be appropriate to discuss the likelihood that additional financing would be available, and which channels might be used (rights issues or private placements for instance in the case of equity, or other forms of finance). The impact of changes in a company's credit rating will be relevant in this regard, and more organisations are disclosing such changes at the present time.

Example 1

Update on liquidity including CCFF draw down

'As anticipated in our update on 23 March 2020, the Group has been confirmed as an eligible issuer for the UK Government's CCFF scheme, with an issuer limit of £300m based on its credit ratings under the terms of the scheme as published by the Bank of England. Yesterday we requested a £300m issuance of commercial paper through the scheme to further enhance our robust level of liquidity.

As at 21 April 2020 (i.e. prior to the drawings made under the CCFF facility announced today), the Group's undrawn committed headroom and free cash had increased to c.£ 500m. This comprised £190m in free cash and £310m of undrawn committed bank revolving credit facilities and represents an improvement of c.£100m compared with the position at the end of February 2020. Therefore, with the drawings under the CCFF facility announced today, the Group has undrawn committed headroom and free cash of c.£800m.

The Group's committed bank facilities include the £800m revolving credit facility which matures in November 2023 and a £250m bank bridge facility for the refinancing of the April 2021 bond. The Group's free cash is in addition to the ring-fenced cash inside our rail franchise operations. In addition to vehicle leasing facilities, the Group also has access to a £150m accordion feature on the bank revolving credit facility and available supplier financing arrangements of more than $100m.

On 1 April 2020 Fitch Ratings maintained its long-term Issuer Default Rating (IDR) at BBB- whilst revising the outlook to negative from stable.'

[First Group > RNS Business and liquidity update > 24 March 2020 **(Extracts only)**]

A. Liquidity, going concern and material uncertainties (cont'd)

Example 2

Funding

'We have run scenario analysis assuming that our fleet remains fully grounded for 3 months, 6 months and 9 months, using the following assumptions:

- The ratio of passengers who choose a refund versus a non-cash alternative, namely a voucher or a later-dated flight, continues at a similar rate to our recent experience
- Our staff remain on furlough leave until the end of May
- No material change to card acquirer arrangements
- No material changes in FX or fuel rates
- Revenue from new bookings remains minimal.

This analysis has shown that we have sufficient cash reserves to remain liquid across a number of scenarios:

- During a 3-month grounding easyJet would use around £1.2bn in cash
- During a 6-month grounding we would use around £2.2bn in cash
- During a 9-month grounding we would use around £3.0bn in cash.

Given the possibility of a prolonged grounding easyJet will continue to consider further liquidity and funding options.

During a prolonged grounding there would be opportunities to further defer maintenance spending. Additional government support could be sought, around extended furlough leave and tax relief. Further operational and organisational changes could be made.'

[easyJet > RNS Trading update for six months to 31 March 2020 > 16 April 2020 **(Extracts only)**]

A. Liquidity, going concern and material uncertainties (cont'd)

A. Liquidity, going concern and material uncertainties
B. Viability statement/sustainability of the business model

Q4: What changes to the going concern assessment might need to be disclosed?

A: The FRC guidance encourages boards, in relation to going concern, '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'.

Although sensitivity analysis has been widely used in going concern assessments, the use of specific scenarios has generally been associated with the assessment of viability. As with viability disclosures, the more useful reporting on this will be clear about not just the nature of the scenarios, but the parameters used and the headroom that would result.

The FRC guidance also notes that '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', so parameters relating both to the duration of the crisis (and its after effects) and the magnitude of its impact are likely to be relevant.

Reverse stress testing (that is, modelling what scenarios or stresses could cause the company to cease to be a going concern) is encouraged in the FRC guidance for the viability assessment so could be equally valuable here. Reverse stress testing can be an efficient way of getting to the impact of a worst case scenario, though only scenarios with more than a remote possibility of occurring would need to be taken into account when deciding whether there is a material uncertainty to disclose.

Q5: What should be disclosed when a material uncertainty is identified?

A: The FRC guidance states that where a material uncertainty exists a 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'. In connection with COVID-19, any of the factors discussed above could therefore be relevant to this disclosure.

The external auditors are required to determine whether the financial statements:

a. Appropriately disclose the principal events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and management's plans to deal with these events or conditions and

b. Disclose clearly that there is a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern and, therefore, that it may be unable to realise its assets and discharge its liabilities in the normal course of business.

A. Liquidity, going concern and material uncertainties (cont'd)

Q6: What should be disclosed when a company does not believe that the crisis will affect it significantly?

A: The FRC guidance points out that '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'.

Where a board concludes that there has been no need for significant judgement, such disclosure would not be needed but it would still be advisable to explain the judgement using the relevant aspects of the guidance above.

Q7: What is the relevance of liquidity, going concern and material uncertainties for forms of reporting other than the annual report?

Going concern is a fundamental accounting principle under both IFRS and UK GAAP so it should be considered in relation to any set of financial statements prepared under those frameworks.

The Listing Rules require companies reporting against the UK Corporate Governance Code to include a statement on going concern in both the annual and half yearly report. This is often done in the 'front half' of the report but can also be covered by disclosures in the financial statements.

The FRC's guidance to companies on the reporting impact of COVID-19 includes at the end a section on half-yearly/interim reports which focuses on going concern matters.

Where a company issues a preliminary announcement the Listing Rules also require that it 'must give details of the nature of any likely modification or emphasis-of-matter paragraph that may be contained in the auditors' report', which would include details of any material uncertainties for going concern.

Other RNS announcements do not have to refer to going concern specifically but often contain information that will be relevant to the going concern (and viability) assessments. Many companies are currently referring to uncertainty about trading in the months to come in their RNSs and this will need to be considered in any report to which the going concern assessment is relevant.

A. Liquidity, going concern and material uncertainties (cont'd)

Example 3

Coronavirus – Summary of impact assessment

'Levels of uncertainty

We have no experience of a similar crisis so there is no way of predicting the extent that the effect coronavirus will have on our Retail and Online sales. It is not yet clear how widespread the virus will be at any one time, how long the pandemic will last and what the medium to long term effect of this pandemic will be on consumer behaviour.

What we can say

The evidence we have from sales to date in the UK and from our (small) international websites in the worst affected countries is that:

- Demand will be the biggest issue and although the virus is likely to impact our operations, we do not believe this will be as damaging as the very significant drop in sales sustained both in Retail and Online
- Online sales are likely to fare better than Retail but will also suffer significant losses. People do not buy a new outfit to stay at home. There is some evidence from our overseas sites that as restrictions on movement increase, the difference between Online and Retail sales performance widens, with Online picking up a small amount of the business that cannot be carried out in store
- Some product areas are likely to fare better than others. To date, our homeware and childrenswear sales appear to be less affected than our adult clothing lines.

Coronavirus stress test

In our Outlook section (page 38) we have included a detailed stress test that gives the likely cash and profit impact for different levels of sales decline. The scenarios model full price sales losses of £445m, £820m and £1bn respectively. These declines represent -10%, -20% and -25% of our annual turnover.

A. Liquidity, going concern and material uncertainties (cont'd)

Example 3 (cont'd)

Measures we can take to conserve cash

The stress test details various measures we could take to control costs and conserve cash within the business, given differing levels of sales decline. These potential measures include the suspension of our buyback programme, the delay of discretionary capital expenditure, the sale and leaseback of a warehouse, the part securitisation of customer receivables, the redemption of a loan to our Employee Share Ownership Trust (ESOT) and if necessary, the deferral of our August dividend. Beyond that we, of course, have the option to suspend rather than delay dividends.

Combined, actions to conserve cash could retain within the business an additional +£835m of cash. These actions would mean that should the Company lose -20% of annual full price sales we would still have £835m headroom within our current bank and bond facilities at the end of the year.

Conclusion of stress test

The conclusion of our stress test is that the business could comfortably sustain the loss of more than £1bn (25%) of annual full price sales, without exceeding our current bond and bank facilities. This accounts for the business rates holiday announced by Government but excludes any use of Government lending or any measures that may be introduced to help with wages during closure.'

[Next > Annual report 2020, pages 5-6 (**Extracts only**); subsequently updated by a further RNS announcement on 29 April 2020]

B. Viability statement/sustainability of the business model

Viability statements look out beyond the horizon of the going concern confirmation, but they also cross over with it in the early part of the viability period. Much of the FRC's guidance on going concern will therefore also be relevant to viability assessments, and the two statements should be fully consistent in their messages. In particular, a material uncertainty for going concern should also be highlighted in the viability statement, at least through a cross-reference, and the potential impact of matters that were not regarded as material uncertainties for going concern on the basis of their timing should be picked up in the viability assessment and disclosure. This could include the medium-term impact of measures to address the immediate crisis.

The longer term information included in viability statements might be regarded as less critical in the early stages of the crisis. As time goes on, and as the impact of the crisis on the wider prospects for the business becomes clearer, these aspects will move back into the spotlight.

For companies reporting against the UK Corporate Governance Code, the new disclosures around the sustainability of the business model could be relevant both in the short and longer terms. Adaptations to the business model are often being made to deal with the immediate impacts of the crisis (such as shifting to an online service offering), but further adaptations may well be needed as the situation unfolds.

Q8: Does the COVID-19 crisis mean that the period for which viability is confirmed might be shorter than was previously the case?

A: Unless a company also has a going concern issue, or believes that the crisis will affect the sustainability of its business model in a fundamental way within the chosen time horizon, we would not generally expect the period chosen for the viability statement to be shortened. In fact, to change the period over which viability is confirmed would most likely also indicate that there could be a material uncertainty for going concern (as that should take into account all available information about the future under IAS 1 paragraph 26).

Q9: The COVID-19 crisis clearly increases the level of uncertainty affecting many companies. How should this be reflected in the viability statement?

A: The FRC recognises in its guidance that the current systemic uncertainty means that some boards will be less confident in stating that they have the 'reasonable expectation' of remaining in business for the relevant period that the viability statement calls for. As a result, the FRC states that 'during the current emergency and unprecedented pace of change, any reasonable level of expectation would naturally carry a much lower level of confidence' than it would under normal circumstances.

B. Viability statement/sustainability of the business model (cont'd)

The key, as always with viability statements, is to be clear on the basis on which the statement is made, setting out the relevant assumptions and any qualifications. A material uncertainty for going concern purposes would effectively amount to a qualification of the viability statement. The assumptions that are disclosed will often be vital to explaining why the period used for the statement has not been changed (see the previous question), including where a matter was not judged to be a material uncertainty only because the time frame is expected to allow mitigating actions to be taken.

Q10: What effect might the crisis have on the disclosure of stress testing in viability statements?

A: It is clear that COVID-19 related factors will need to be added to their stress and scenario testing by most companies. The scenarios should take account of appropriate authority on the duration and shape of the crisis. They should also recognise the connections between risks and developments and the knock-on effects that can be triggered, such as the relationship between trading results, credit ratings and future financing needs.

As noted earlier, reverse stress testing for the factors that would cause a company to cease to be viable is recommended by the FRC in its guidance and can be an efficient way of arriving at what would be a plausible worst case scenario.

The extent of the testing and the quality of the related disclosures will be an important part of the comfort investors and other stakeholders are able to take from the reporting, and there is evidence that the disclosure of stress testing done in relation to COVID-19 related matters has sometimes been more detailed and insightful than has generally been the case for other stress testing disclosures – but most companies can certainly still do more. We continue to believe that a viability statement should include stress or scenario testing that is clear on the parameters used and the headroom that exists in relation to them, and this applies to COVID-19 related factors as much as to any other.

Q11: What sorts of factors might be relevant to include in viability disclosures about the potential longer term impacts of the COVID-19 crisis?

As the longer term effects start to become clear (which **could** start to be the case in time for the main 2020/21 reporting season), companies should explore and explain how changes in the business, industry and the wider social and economic environment might mean that the business model needs to be adapted (or adapted again where changes were already made to deal with short-term issues). Such changes could relate to the whole range of a company's stakeholders, depending on the nature of the business.

2

Governance, risk and internal control

A. Principal risks and uncertainties

COVID-19 has clearly generated additional risk and uncertainty for many companies, some of which has already crystallised and some of which has not. The extent of the exposure varies between businesses and industries and will change as the crisis develops. Key reporting priorities are therefore to be company-specific and clear on the timeline as well, of course, as on the likelihood of the remaining risk crystallising and the magnitude of the impact if it did. Hindsight will no doubt also generate questions about why more companies have not identified 'pandemic risk' or similar in the past, especially where the impact of COVID-19 is particularly serious.

Q1: Is COVID-19 a principal risk?

A: The impact of the crisis will vary from company to company, and over time, but there will usually be something to include in the disclosure of principal risks and uncertainties under the Companies Act 2006. The approach taken should reflect the specific circumstances and a number of different methods are being used. The better disclosures generally address two issues:

- How the company is dealing with the risks associated with the current crisis from the point of view of the company's business resilience processes
- How the crisis is affecting the company's ongoing principal risks and potentially generating new principal risks.

Where risks have changed companies should ensure they explain the movements well in both the half-yearly and annual report.

A number of companies are also addressing the risk that similar events will happen in the future. In some cases companies had already referred to pandemics in their principal risks (though these were usually where the risks were closer to US-style 'risk factors' than UK-style principal risks).

Q2: Is COVID-19 an emerging risk?

A: See the response above for how new principal risks might be created as a result of COVID-19.

The term 'emerging risk' is used differently by different companies, often in connection with the reference to such risks in the 2018 UK Corporate Governance Code. It seems reasonable to regard COVID-19 as **having** emerged and being in the process of impacting on companies, but some treat the more recent risks (principal or not) as 'emerging' and some also classify any risk that originates outside the business in that way. The definition used is less important than making good disclosure of the reporting priorities discussed above.

A. Principal risks and uncertainties (cont'd)

Q3: Is it appropriate to give all the COVID-19 related information in the risks section?

A: It's unlikely that all the COVID-19 related information can be properly reflected in principal risk disclosures. The rest of the risk section is generally more flexible so it could be done there, though it would mean bringing content into the risk section which is not directly focused on risk.

Given the significance of the issue for many companies it will often be appropriate for the CEO and/or chair to include the main COVID-19 discussions in their statements, or – an approach that can work well – as a separate panel or page near the start of the report. It's particularly important for there to be a proper overview of the impact on the company and clear conclusions about the current assessment of the situation. These will, however, need to be supplemented by appropriate content elsewhere such as in the viability statement and the other parts of the annual report discussed in this guidance.

Q4: Should black swans now be addressed in principal risks?

A: COVID-19 and its implications are generally regarded as an example of a high impact, low likelihood risk event, a category which at least crosses over with 'black swans'. Companies should certainly consider whether such events are appropriately factored into risk identification and risk management processes and whether they should be included in principal (or emerging) risks. It will generally be difficult to provide extensive detail about them, however, such as quantification of the potential financial effects.

Companies should also bear in mind the risk that the COVID-19 crisis will be a recurring issue, and deal with how they would respond if government measures were reimposed after having been lifted for a period.

B. Governance, risk management and internal control

In its guidance the FRC is clear that reporting should address how COVID-19 has affected the operation of a company's systems of governance, risk management and internal control, including the quality of information that is available for decision making. This is important in that it can help to provide comfort to investors and other stakeholders that both management and the board are properly engaged with, and in a position to address, the most important aspects of the situation.

Q5: What changes to board activities might need to be reported?

A: It would be reasonable for investors and other stakeholders to expect boards to convene more often as a result of COVID-19, so it makes sense to show that this has been the case (or to explain why not), including how this was achieved in an efficient and effective way – particularly while social distancing is in place.

The working relationship between the chair and CEO is often particularly important. Any issues with the health or availability of either of these individuals could be critical, and it would also be advisable to explain how they are continuing to work effectively together during the crisis period.

The primary focus in these disclosures should of course be on how the principal decisions were taken – of which there are likely to be more as a result of the crisis. See also Section 3 > Balancing the interests of shareholders and other stakeholders on s172 and the stakeholder agenda.

'Overboarding' is the term used by investors when directors are thought to have too many roles. Given the likely increase in board activities due to COVID-19, investors might be concerned that directors are spread too thin between commitments, so the annual report also presents an opportunity to address this.

Q6: What risks might need to be reported on in relation to the underlying systems of risk management and internal control?

A: This will of course vary from case to case but examples include:

- With many employees being instructed by governments to work remotely where possible, companies have increased their use of technology for communication purposes. The reliability and security of the chosen platforms could therefore be important to reflect
- There may also be manual aspects to the control environment which it is not possible to maintain to the usual standards
- The availability and health of the key members of the workforce, including specialists, may also need to be considered – particularly where there are small teams
- Lack of direction or motivation can set in, reducing the effectiveness of systems and controls.

B. Governance, risk management and internal control (cont'd)

Each of these matters could represent an emerging or principal risk to the business, at least for a time, and therefore the mitigating actions taken in response should be disclosed to the appropriate extent.

There could also be effects on how the company's risk appetite is applied on a day to day basis as a result of new perceptions of the company's priorities or because of changes in the staff responsible.

Q7: What might be relevant to report in relation to the work of internal audit?

A: There has been a significant focus on the work of external auditors since the crisis started, with specific guidance from the FRC about how to deal with some of the logistical and other challenges that arise such as access to sites and international travel restrictions, but there has been no equivalent in relation to internal auditors.

Internal audit staff will of course be subject to the same factors as discussed above, which could reduce the effectiveness of the function and significantly affect the overall control environment.

On the other hand, internal audit teams can play an important role in helping to address new areas of risk, provided that they have the appropriate skillset. This includes providing assurance over the quality of the information being provided for decision making, including any new COVID-19-related management information.

The audit committee is responsible for monitoring and reviewing the effectiveness of the company's internal audit function so it would be advisable for the committee to report on how matters such as those set out above have been addressed where applicable.

Q8: Is there any guidance on where reporting on the impact of the crisis on risk management and internal control might it sit in the annual report?

A: The board is required to monitor and review the effectiveness of the risk management and internal controls systems at least annually and, in its **Guidance on risk management, internal control and related financial and business reporting**, the FRC sets out what this review should cover (see the panel below).

To the extent that they are not already addressed elsewhere, it would be reasonable to incorporate the outcome of this assessment in the corporate governance report – most likely the audit committee report – explaining how the directors have considered the impact on the systems and information received, along with any mitigating actions (or significant failings or weaknesses). It could also be included in the overview of a company's COVID-19 assessment advocated earlier.

In the current climate, it might well also be appropriate for companies to include information relating to risk management and internal control in an RNS announcement or the half-yearly report.

B. Governance, risk management and internal control (cont'd)

A. Principal risks and uncertainties

B. Governance, risk management and internal control

The annual review of effectiveness should, in particular, consider:

- the company's willingness to take on risk (its 'risk appetite'), the desired culture within the company and whether this culture has been embedded;
- the operation of the risk management and internal control systems, covering the design, implementation, monitoring and review and identification of risks and determination of those which are principal to the company;
- the integration of risk management and internal controls with considerations of strategy and business model, and with business planning processes;
- the changes in the nature, likelihood and impact of principal risks, and the company's ability to respond to changes in its business and the external environment;
- the extent, frequency and quality of the communication of the results of management's monitoring to the board which enables it to build up a cumulative assessment of the state of control in the company and the effectiveness with which risk is being managed or mitigated;
- issues dealt with in reports reviewed by the board during the year, in particular the incidence of significant control failings or weaknesses that have been identified at any time during the period and the extent to which they have, or could have, resulted in unforeseen impact; and
- the effectiveness of the company's public reporting processes.

[FRC Guidance on risk management, internal control, and related financial and business reporting Paragraph 43]

3

Balancing the interests of shareholders and other stakeholders

Balancing the interests of shareholders and other stakeholders

When the COVID-19 crisis struck, stakeholder issues (including environmental issues like climate change) were high on board agendas. They were also at the top of the reporting agenda, with new reporting for many UK companies on how directors have regard for their duties under section 172 of the Companies Act, and on the engagement of the board with employees and other stakeholders in relation to their principal decisions. See below for more information on these requirements. The 2018 version of the UK Corporate Governance Code reinforced this, and added a wider set of factors to consider around the purpose, culture and values of companies.

The timing of this set of initiatives has turned out to be good, and the impact of COVID-19 has turned the spotlight firmly on how boards consider many of the related issues in their decision making, particularly how they strike the right balance between the interests of shareholders and the other stakeholder groups (including employees, customers, suppliers and those in wider society with whom the business has a relationship) in circumstances where the future is so uncertain.

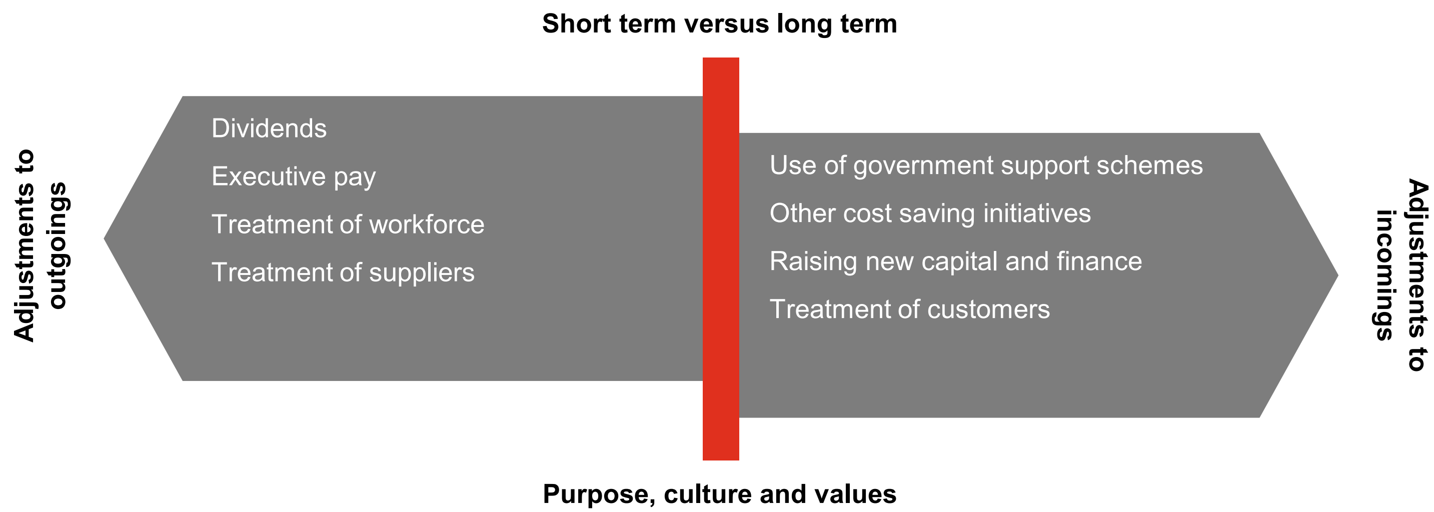
In this context good reporting will explain the balance that has been struck, and why, in decisions including:

- Whether or not to pay **dividends** (or return capital in other ways)
- Whether and how to **raise more capital** or **other forms of finance**
- The treatment of **employees and the wider workforce** (including changes to pay and conditions)
- **Executive pay** (including bonus entitlements and long-term incentive schemes)
- The treatment of **customers and suppliers**
- The use of the various forms of **government support** that are potentially available
- Other **capital allocation decisions** including whether to cancel or scale back capital expenditure, research and development and so on.

Balancing the interests of shareholders and other stakeholders (cont'd)

The emphasis that section 172 puts on having regard to the long-term consequences of decisions of this kind is also even more significant than ever as boards are often working to balance the short-term survival of the organisation with its long-term goals and stated purpose, culture and values. The sections below on the new reporting requirements, dividend policy, and executive pay look in more detail at these decisions.

Figure 2: Balancing board decision making



A. COVID-19 and the new reporting requirements

Q1: How does COVID-19 impact the new section 172 statement?

A: COVID-19 has potential implications for every part of section 172 and, where it has affected the decisions directors take, it will be important to explain this carefully in the new section 172 reporting: short-term survival can mean that decisions are different from those that would be made in other contexts and it is very easy to send the wrong message without proper explanation. Many organisations will of course be keen to show that their focus on the health and safety of the workforce has not reduced.

Where these explanations are not addressed elsewhere, case studies on the relevant decisions can be a good way for the board to describe the various factors it considered when making decisions around capital allocation and other strategic matters. See also the discussion on reporting against the revised UK Corporate Governance Code below.

Section 172: Duty to promote the success of the company

1. A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to:
   a. the likely consequences of any decision in the long term,
   b. the interests of the company's employees,
   c. the need to foster the company's business relationships with suppliers, customers and others,
   d. the impact of the company's operations on the community and the environment,
   e. the desirability of the company maintaining a reputation for high standards of business conduct, and
   f. the need to act fairly as between members of the company.

A. COVID-19 and the new reporting requirements (cont'd)

Q2: How does COVID-19 impact the new stakeholder engagement disclosures?

A: COVID-19 simultaneously makes stakeholder engagement more important and more difficult.

The impact on the **workforce** depends on the nature of the business and will change as the crisis moves on, but good communication will be vital at all stages to address concerns, retain goodwill and maintain motivation. Good external reporting will help to show that consultation has happened, even in difficult circumstances like reductions in pay or bonuses, redundancy programmes or the use of furlough schemes.

Many companies were already using technology up to a point but online tools are likely to be even more important for workforce engagement in the early stages of the crisis in particular. The revised UK Corporate Governance Code calls for companies to have one or more specific mechanisms in place for board-level engagement, and all of these (including the popular options of designating a non-executive director and establishing a formal workplace forum) will depend on technology to a significant extent at the present time.

Other stakeholder communications and relationships will also continue to be important for short-term survival and longer-term recovery. Examples of this that it might be appropriate to report on include:

- Relationships with suppliers and those in their own supply chain (including over any delays in payment)
- Treatment of customers (including those having difficulty paying, or who are potentially due refunds)
- Relationships with landlords and other lessors (particularly in the retail sector).

A. COVID-19 and the new reporting requirements (cont'd)

Example 4

Our colleagues

'Our top priority is the safety, health and wellbeing of our 15,000 people. We are closely monitoring developments in the COVID-19 outbreak and are taking the appropriate steps to help maintain the ongoing health and safety of our employees. Johnson Matthey has:

- Enabled working from home arrangements for all roles that can do so;
- Ensured the highest standards of safety in all working practices;
- Enhanced our existing health and wellbeing support for all employees;
- Put self-isolation procedures in place for employees who are displaying symptoms or have been in contact with a confirmed infected individual;
- Decided that we will not take any COVID-19 support from the UK government for furloughed staff during April, May and June 2020 (Q1 of our 2020/21 financial year); and
- Pledged to make no member of staff redundant as a direct result of the impact of COVID-19-19 until the end of June 2020.

Our customers and suppliers

Johnson Matthey is an important part of the value chains that are providing vital products and services to the healthcare industry, and that are maintaining food and energy supplies during COVID-19. We have:

- Kept operations running for customers where it is safe to do so and where government measures allow, so we are there when they need us;
- Maintained our payment terms to support all of our suppliers; and
- Pledged to support any small supplier to our business that is suffering hardship and requests early payment terms as a result of the impact of COVID-19 during April, May and June 2020.'

[Johnson Matthey > RNS Supporting our stakeholders for today, and for the future > 22 April 2020 (**Extracts only**)]

A. COVID-19 and the new reporting requirements (cont'd)

Q3: What impact might COVID-19 have on environmental disclosures?

A: The situation is having a significant short-term impact on energy use and the CO2 emissions associated with climate change and could potentially affect these in the longer term too, particularly where it changes consumer behaviours.

Companies will need to address these impacts in the narrative around their disclosures on climate change, and in the new narrative reporting element of the Streamlined Energy and Carbon Reporting ('SECR') requirements that apply for financial periods beginning on or after 1 April 2019. In order for the annual report to be fair and balanced it may also be necessary to discuss the underlying longer-term trends in a company's energy use and emissions.

Q4: How might reporting under the 2018 UK Corporate Governance Code be affected by COVID-19?

A: The 2018 Code focuses on how the principles have been applied, and shifts away from a tick-box approach based only on the detailed provisions of the Code. As the FRC puts it in the Introduction to the Code: 'Reporting should cover the application of the Principles in the context of the particular circumstances of the company and how the board has set the company's purpose and strategy, met objectives and achieved outcomes through the decisions it has taken'. In order to do this, companies will need to reflect how governance has been **applied** to the COVID-19 situation and its impact on decision making and the delivery of the company's strategy. Many COVID-19 related decisions will fall within the matters reserved for the board.

Consistent with the Q&A on section 172 (which is also referred to in the Code), case studies are likely to be a useful way to show how governance has been applied, as is the chair's introduction to the governance report.

The impact of COVID-19 is generating widespread debate about the purpose, culture and values of companies so the revisions to the Code has been timely. In the short term many businesses have been keen to show that they are offering help to government and the wider community, and there will no doubt be questions about how the relationship between business and society might change in the longer term. Many companies have already issued communications about the initiatives they have taken and we expect to see much more on this in half-yearly and annual reports as they emerge.

B. COVID-19 and dividend policy

Dividend policy has become a sensitive issue for many companies, whether or not they plan to postpone or cancel the payment of a dividend. It is among the highest profile examples of the need to balance the interests of shareholders and other stakeholders and there can be reputational risk for companies whatever they choose to do.

> The Link Group's quarterly dividend monitor for Q1 2020 showed that so far 45% of a sample of 350 UK companies (including the FTSE 100 and 60% of the FTSE 350 plus around 100 smaller listed companies) had decided against paying dividends in 2020.

Q5: What are the issues to consider in relation to reporting on dividend policy as a result of COVID-19?

A: As always, the circumstances and factors to consider will vary from company to company and over the course of the situation, but the following will often be relevant to the policy decision and therefore the disclosures.

The need to **balance** the interests of shareholders with those of other stakeholders, in the context of the other actions taken in response to the impact of COVID-19: a number of companies have already suffered potential reputational damage as a result of continuing to pay substantial dividends when taking advantage of government support schemes, for instance.

The **difficulty of forecasting** future capital needs in the current situation:

- Particularly relevant in the initial stages of the crisis, the FRC guidance reminds companies that in order for a dividend to be legal, 'directors need to consider not only the position of the company when the dividend was proposed but also when it is made' – a company's situation could change quickly at the present time, and new dividend blocks could be created within a group structure by issues such as the impairment of an investment in a subsidiary
- Forecasting for the longer term may be even more difficult, and decisions taken now will be looked at with hindsight, particularly if the company finds itself needing new finance or other forms of support in the future.

The **consistency** of policy decisions, which might reflect the short-term priorities of companies at the present time, with the nature of the company's longer-term investment proposition and the composition of its shareholder register. A stock which has historically been held because of a reliable and steadily increasing dividend stream will be in a different position from a capital growth stock. And a very widely held company will have different issues to consider from one which is closely controlled.

B. COVID-19 and dividend policy (cont'd)

The following is a good source of guidance on dividend policy disclosures from the FRC Reporting Lab: Disclosure of dividends – policy and practice. See also the FAQs in this PwC guidance.

Investor views

Investors are generally keen to support companies through the crisis, including in connection with dividend decisions.

On behalf of its members, the Investment Association has supported the need for companies to consider dividends carefully, but also noted the importance of this income for pension funds and charities, who '...would be concerned if companies unnecessarily reduced or rebased the dividend level…[and] would expect companies…to restart the dividend payments as soon as it is prudent to do so'. [Letter to FTSE Chairs, 8 April 2020].

The Pre-Emption Group has issued a statement recommending investors consider supporting issuances of up to 20% of share capital (rather than the previous 5% for general corporate purposes with an additional 5% for specified acquisitions or investment) on a case-by-case basis. This has been supported by the Investment Association and other institutions such as ISS. A number of retail investor groups have expressed concerns that their interests are not being appropriately considered, however, again showing the importance of striking the right balance between the various stakeholder groups.

C. COVID-19 and executive pay

Executive pay remains a high-profile and sensitive topic, and there is always a risk that decisions about policies and their implementation in this area will lead to reputational damage for companies. The COVID-19 response is again serving as a test-bed for the greater transparency that is called for in the 2018 UK Corporate Governance Code, and its encouragement for remuneration committees to exercise discretion.

In some cases, including banks and insurers, the regulator (in those cases, the PRA) has mandated a particular approach to aspects of pay. In non-regulated industries, investors have heavily discouraged the payment of variable executive remuneration that could be funded by government support or unpaid dividends.

Investor views

The Investment Association ('IA') has issued a particularly targeted set of guidance for remuneration committees and advisers as to the expectations of their members for how the COVID-19 crisis might affect executive pay. IA members' expectations include the following, which it would be advisable for companies to consider when drafting the relevant reporting:

Executive pay should be **aligned** with 'the experience of the company, its employees and its other stakeholders'. So:

- Remuneration committees should consider making appropriate adjustments to FY19 bonuses (or FY20 if not possible) where a dividend has been suspended or cancelled
- There will be support for companies proposing temporary salary reductions or freezing variable pay in situations such as where employees are furloughed or additional capital needs to be raised.

With regard to **performance conditions**:

- Those for ongoing bonus schemes and in-flight long-term incentive plans ('LTIPs') should not be adjusted, but discretion should be used where outcomes are inconsistent with current company performance or shareholder experience – all subject to proper engagement and disclosure
- The grant size of FY20 LTIPs that have already been awarded does not have to be adjusted, subject to remuneration committee discretion to reduce any windfall gains that would result from significant upward movement in the share price.

C. COVID-19 and executive pay (cont'd)

Investor views (cont'd)

Looking ahead:

- With the highly uncertain market environment, companies should consider carefully whether the terms and conditions of new LTIPs can properly be set at present and the idea of delaying either the grant or the setting of performance conditions for up to six months is supported
- Where appropriate due the effects of the crisis, companies may decide not to make substantial changes to remuneration policy
- Overall, the IA recognises that 'remuneration committees will need to sensitively balance the need to continue to incentivise executive performance at a time where management teams are being asked to demonstrate significant leadership and resilience and ensure the executive experience is commensurate with that of shareholders, employees and other stakeholders'.

Q6: What should be disclosed where only a small part of the year to which executive pay relates was affected by COVID-19?

A: Although the main impact of COVID-19 may have been after the balance sheet date, a significant amount of remuneration committee time is likely to have been spent since the end of the financial year in considering whether directors' remuneration for the financial year should be adjusted in ways such as those encouraged by the Investment Association. The decisions reached on incentive outcomes and any use of discretion should be set out in detail.

Consistent with the messages of Section 3 above, it's important to present the remuneration committee's decisions in the context of the treatment of the wider workforce and shareholder experience. The tone set in the remuneration committee chair's statement, in particular, is likely to influence the reader's assessment of whether the decisions made in respect of executive remuneration are appropriate.

Q7: Will many companies find they need to change their remuneration policies as a result of COVID-19?

A: Generally, the actions companies are taking (such as temporary salary reductions or freezing variable pay) are more in the nature of how the approved policy is implemented rather than changes to the policy itself. It is unlikely that a company will make changes impacting the policy that, in many cases, will be put to shareholder vote at the forthcoming AGM.

C. COVID-19 and executive pay (cont'd)

Q8: What are some of the potential impacts on directors' remuneration report disclosures, including the single total figure table?

A: **Temporary salary reductions** are not likely to affect the single total figure substantially before 31 March 2020 due to the timing of the crisis but, when they do, there may be an impact. For example, where an element of remuneration is waived such that the director has no further influence over how the funds are used, it will generally not be necessary to include those amounts in the single total figure table.

In respect of **annual bonuses**, although there may be uncertainty it is not possible to maintain an open position on this in the directors' remuneration report, and companies should make their best estimate of the bonus payable. There is the facility in the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (as amended) ('the Regulations') to restate amounts that are estimated in the single total figure for a financial year when these are disclosed as prior year comparators. The challenge for this is that the inclusion of any estimated amount (whether the amount that would be payable in the absence of the crisis or £nil) will set expectations and will need robust justification.

When an amount needs to be included in the single total figure table for **LTIPs** that will vest after the year end but not before the annual report is finalised, the share price for the last quarter of the financial year must be used under the Regulations, even if it is not representative of the share price at vesting as a result of a COVID-19-related fall.

4

The impact on a company's financial results

The impact on a company's financial results

The impact on a company's financial results

Reporting well on the impact that COVID-19 has had on a company's performance will of course be a fundamental part of informing investors and other stakeholders about the position and resilience of the business. It could also have a significant impact on whether companies successfully build and maintain support and trust through reporting in a way that is seen as properly fair, balanced and understandable.

A number of aspects of how the crisis affects aspects of the business that are not directly financial have been addressed in earlier Q&As, particularly in Section 3 > Balancing the interests of shareholders and other stakeholders.

The methods that companies will need to use to report on their financial performance are likely to vary over the life of the crisis and its aftermath, as the Q&As below set out.

Q1: How might COVID-19 affect reporting on company performance in the short term?

A: The core results of companies with financial years ended up to March 2020 will generally not be substantially affected by the impact of COVID-19, as government restrictions began in earnest towards the end of March. There will often be significant impairment charges where the year end occurred after the crisis had begun, but few companies are likely to feel it necessary to introduce alternative performance measures ('APMs') relating to impact on their core trading: the principal focus of their reporting will generally be on the balance sheet strength of the company and on narrative disclosures around the impact of the crisis going forward. See Section 1 > Going concern and viability for more discussion of these issues.

Q2: How might COVID-19 affect reporting on company performance in the medium and longer term?

A: The results for periods ending after March 2020 will start to be significantly affected by the crisis, with the half-yearly reports of December year end companies being the first major batch to be published.

These reports might feature APMs in relation to the impact of COVID-19. It will be important, as always with APMs and exceptional items, for companies to establish clear policies on what can and cannot be included, how it will be calculated, and from what point in time.

The crisis will also have an impact on internal management information as new or revised performance indicators ('KPIs') are introduced to track priority issues. These will also need to be reflected appropriately in the external reporting of KPIs.

The impact on a company's financial results (cont'd)

Companies will need to consider carefully whether the impacts on the business are best reflected as APMs, and ESMA has updated the Q&As on its Guidelines on the use of APMs to include a new question specifically on COVID-19. This reminds companies that they 'should carefully assess whether the intended adjustments or new APMs would provide transparent and useful information to the market, improve comparability, reliability and/or comprehensibility of APMs and financial information'.

ESMA particularly discourages new or adjusted APMs where COVID-19 has a pervasive effect on a company. In such circumstances the guidance is to focus on appropriate narrative explanations of how COVID-19 has impacted and/or is expected to impact its operations and performance. These explanations may however include, where applicable 'details on how the specific circumstances related to COVID-19 affected the assumptions and estimates used in the determination of inputs to APMs, for example impairment losses, expected lease payment reductions or grants received'.

The longer term impact of COVID-19 could become pervasive for many companies if it persists. Depending on when the crisis is substantially over, there may be a period within the relevant financial year that can easily be looked at in isolation or it may be the whole period that is impacted and the effect can not be easily isolated.

Q3: How can major reductions in revenue be reported on?

A: It is not possible to adjust for these in the way that APMs are normally used as the missing revenue can not be shown as a deduction or added back. Again, narrative disclosure will need to be used to explain the effects – and to discuss the prospects going forward.

Where it is provided, market guidance for the current financial year has been withdrawn for most companies, and there will be a desire to replace this in due course to give investors a view on the ongoing, underlying business. The ability to do this, including providing guidance on revenue, will depend on the nature of the business and the timeline of the crisis but it will be very challenging for most to do so in the near future. Disclosures around liquidity, going concern and viability – including stress testing, scenarios and key assumptions – may in any case often be more relevant.

To find out how PwC UK is responding to COVID-19, please visit: www.pwc.co.uk/COVID19businesscontinuity

For our latest insights and resources, please visit: www.pwc.co.uk/COVID-19

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