39

VIABILITY

Steve Maslin

Little has damaged confidence in the capital markets like a sudden and catastrophic loss of shareholder value. The causes may change (tiger economies, accounting fraud, technology innovation, hubris, systemic banking collapse, pandemic), and regulation and oversight have taken off exponentially, but still, we open the financial newspaper pages to see a once famous name disappear almost overnight. How can boards minimise the risk of being the latest casualty?

Financial considerations

Much of the best advice I have received over the years has been the simplest, and nothing has stuck like “there is no long term without a short term.” Larger businesses have learned from the 2008 financial crisis and have built up strong cash reserves to withstand further systemic shocks. However, when working with a new board, one of my first areas of focus is to look at the budgetary and forecasting track record. Overuse of exceptional items to meet profit and cash forecasts has been a warning sign in

many high-profile collapses for decades, but some management teams do not heed that warning.

When evaluating longer-term financial resilience, boards need to consider over what cycle it is feasible to plan. Research by the Financial Reporting Council (FRC)¹ suggested that when the requirement was first introduced for UK-listed entities to publish a viability statement, boards were typically reporting on a three-year horizon. However, my experience is that internally, boards generally consider a period of five to seven years and sometimes longer.

Providers of capital continually reassess their exposures to certain sectors and individual entities, and it is important that the board continue to examine the likely appetite of investors, lenders, and other capital providers to support their longer-term growth plans and to step in should an unforeseen systemic shock occur. It is a mistake in my view to leave this relationship assessment to the finance team. I have always found that regular engagement with key capital providers gives the board a much more sound evaluation of varying support for the entity's ambitions and where alternative funding relationships need to be nurtured.

Linking viability and risk

Clearly, any viability assessment has to be closely linked to the risk register. I believe it is crucial for the audit committee chair to find ways of ensuring that the risk assessment process is a dynamic, forward-looking one, and I invariably start a risk dialogue with a “what is on your mind” session with the CEO and key executives. I still hear of too many risk committees where the agenda is primarily a historical assessment of internal audit. The audit committee's private session with internal and external auditors should also be a rigorous discussion as these functions are a valuable external check on management's approach to risk and the source of what risks are concerning comparator entities.

Stress-testing of key risks, now commonplace in financial services, should be a regular feature of any board and risk committee. Stress-testing needs to be more robust than mere sensitivity analysis and embrace how a

1 FRC Lab Risk and Viability Reporting November 2017.

severe but plausible event could threaten viability. An alternative deployed by some boards is reverse stress-testing, that is, looking at how bad a shock would have to be to threaten the entity's viability and then considering what mitigations can be deployed.

I was lucky enough to witness the media operations room at the London Olympics in 2012. The media provider demonstrated how it was testing its main and back-up systems in real time with mock attacks (national power outage, terrorist incident, fire and so on) to evaluate the resilience of their mitigation plans. As the risk officer put it, asking Usain Bolt to re-run the 100 metres final in a world record time because we lost the feed to 170 countries at the key moment was not an option. It was a great lesson on robust stress-testing.

Purpose and culture

In 2019, Grant Thornton issued research² on governance behaviours of the UK FTSE 350 and demonstrated a measurable correlation between good governance and financial performance and resilience. I use this research when evaluating viability as, by logical extension, poor governance behaviour can lead to suboptimal financial performance.

The research highlighted three areas which appeared to underpin this good governance and financial performance:

- Clarity of purpose and a healthy culture that was embedded throughout the entity
- Deployment of robust risk evaluation and mitigation as a value driver, not just a compliance function
- Employment of a rigorous board effectiveness process and acting quickly on the results.

Again, two simple bits of advice I received on clarity of purpose have stayed with me. First was, "if you cannot say that your business is one of the two leaders in its field, you will always be at risk." The CEO who said this continually examined the markets in which his business operated, and investment

2 www.grantthornton.co.uk/globalassets/1.-member-firms/united-kingdom/pdf/documents/corporate-governance-and-company-performance.pdf.

was always directed towards services that would be market leading. This did not have to be size-based necessarily, but if another measure of leadership was used, it had to be clearly measurable and demonstrable. Second was a CEO who said, “if your business did not exist, would society invent it?” She was passionate about meeting the Mark Carney test in the wake of the financial crisis. That is, if your business does not show a clear benefit to society, what good is it?

Culture is also a massive part of success and viability. Boards need to be curious about what it really feels like to be a part of the entity, from the reception cleaner to the chair’s office and what its people believe is really valued, as this will drive their motivation and behaviour. I have valued the conversations initiated by the more progressive boards in response to recent heightened concerns around race and ethnicity fairness where the experiences of some people are not aligned with those published on the entity’s website. These conversations are painful, but necessary, and curiosity about the actual experiences of people is incredibly important in understanding and shaping culture, and thereby building resilience.

Board effectiveness

To build viable entities, the board effectiveness review needs to take a long-term view of skills and experience needs and lead to a plan to fill gaps before they create a problem. I would hazard a guess that most large entities on all key stock exchanges would have IT resilience and cyberthreat high on their risk registers; but how many have built credible experience within the board so that management’s response can be challenged effectively?

For listed and unlisted entities, understanding shareholder and potential investor sentiment is an important extension of the board effectiveness review. While I was an audit partner, it always surprised me that gaining an insight into investor sentiment was not hard-wired into auditing standards, and these steps were always a key part of my risk assessment of an entity’s viability.

Sustainability

Capital providers are increasingly focused on the entity demonstrating that it has a responsible approach to the environment and use of scarce resources. Following the establishment of the Task Force on Climate Related

Disclosures,³ entities in sectors such as construction might find that their ability to demonstrate a long-term intention to achieve a responsible environmental approach more of a challenge when trying to access new bank loans than the traditional questions around the business plan.

More recently research published by Bloomberg NEF⁴ finds that the Covid-19 pandemic has changed the way investors think of sustainability for the better. The research report states, “Investors are beginning to view companies that prioritize sustainability as more resilient to external shock, making them safer long-term investments.”

The power of diverse thinking

I will close by looking at the power of diverse thinking in building resilience and ensuring viability. For me, *Rebel Ideas* by the brilliant Times sportswriter and former table tennis Olympian Matthew Syed, is essential board reading when considering viability. This book grabbed my attention when he noted the absence of diverse thinking and challenge as the critical flaw that led to two fatal disasters. First was 9/11, where he put the case that a CIA culture that supposed an elite intelligence service was based singularly on white men with an Ivy League education created a blind spot to the emerging threat of al-Qaeda. Second, was a fatal plane crash, where junior crew members failed to challenge the experienced pilot out of undue respect because, they assumed, he had spotted the emergency signals in the cockpit controls even though it was obvious he was distracted by another problem.

If our primeval sense of tribalism and hierarchy can lead to intelligent and experienced people failing to challenge, even if it places their and colleagues’ lives at peril, then we must be open to the danger in the boardroom that even experienced executives and non-executives will fail to challenge sufficiently to avert corporate disaster.

The board cannot maximise the chances of achieving viability unless there is a culture and process of continual, and genuine, challenge.

3 www.fsb-tcfd.org/.

4 <https://t.co/iYfGp1Zh1c>.

Questions to ask

Liquidity

- How reliable are profit and cash forecasts and is there an over-reliance on exceptional items?
- Does management use forward-looking key performance indicators to manage compliance with lending covenants?

Solvency

- How well does the board understand the appetite of key investors and lenders to support future growth and to help to maintain solvency?
- How is the board maintaining a regular dialogue with capital providers to explore mutual business ambitions, outside of the functional finance relationship?

Risk

- What mechanisms are used to ensure that the risk assessment and mitigation is a forward-looking and dynamic one?
- How regularly are risks subject to stress-testing and how rigorous are those stress tests?
- How is the audit committee tapping into relevant experiences of other entities about risks and stress-testing to gain an external perspective?

Purpose

- How does the board ensure clarity of purpose and that purpose is understood by stakeholders inside and outside the entity?
- Can the entity truly claim that each of its business units is one of the two leaders in its market?
- If the entity or individual business units did not exist, would society invent them?

Culture

- How does the board show that it is curious about how well the desired culture is embedded throughout the entity?

- Do our people genuinely exhibit the culture and behaviour that the board desires?

Board effectiveness

- How well are the board, chair, and key committees felt to be working by key stakeholders?
- What will be the key skills and experiences required to achieve plans and challenge business resilience plans over the business plan cycle?

Sustainability

- How well do the entity's plans for a responsible approach to the environment and climate change measure up to other actors in its markets?
- What expectations will key stakeholders (for example, customers, regulators, investors, lenders) place upon the entity over its business cycle?

Diversity

- How does the chair ensure that dissenting views are actively encouraged and the arguments fully explored?
- How regularly are key decisions challenged and debated in the board or relevant committee, or are they routinely nodded through?
- How does the entity explore external views on emerging threats?

Overall

- How has the entity challenged itself that everything feasible has been done to maximise the entity's viability?

The imposition by the FRC for UK-listed companies to publish their viability reports has imposed a helpful discipline – there is nothing like having to commit a plan to writing and subject it to external challenge for driving robust challenge and debate.