March 30, 2020

Joint Statement by the FCA, FRC and PRA Regarding Capital Markets Reporting in Light of Recent COVID-19 Developments

In a joint statement issued on March 26, 2020 (the "Joint Statement") (available here), in response to the COVID-19 pandemic, the UK Financial Conduct Authority ("FCA"), the UK Financial Reporting Council ("FRC") and the UK Prudential Regulation Authority ("PRA") granted temporary relief and issued guidance intended to "ensure information continues to flow to investors and support the continued functioning of the UK's capital markets." The Joint Statement was made in light of the changes to financial reporting and audit practices that may now be inevitable as a result of the increasing challenges posed by COVID-19, including: modified audit opinions resulting from an inability to gather complete information, material uncertainties about a company's immediate outlook and changes to timetables for the publication of financial information that were set before the full impact of COVID-19 was known.

The Joint Statement consists of three parts:

- a statement by the FCA (available here) permitting listed companies to delay the publication of audited financial statements from four to six months after the end of the financial year;
- guidance from the FRC (available here), complemented by guidance from the PRA (available here), for companies preparing financial statements given current market uncertainties; and
- guidance from the FRC (available here) for audit firms.

FCA Statement on the Reporting Timetable for Listed Companies

In light of the challenges facing listed companies as they prepare for the publication of audited financial statements in the current environment, the FCA's recent statement titled, "Statement of Policy: Delaying annual company accounts during the coronavirus crisis," has granted a temporary two-month extension to the current four-month deadline (following year-end). In effect, the FCA will forbear from taking any action against listed companies that publish their financial statements within six months of year-end, and has noted that this forbearance does not constitute a waiver or rule change. This extension applies to all companies that are subject to the FCA's Disclosure Guidance and Transparency Rule ("DTR") 4.1 (Annual financial reports) (i.e., companies with securities admitted to trading whose home member state is the UK), although the FCA also notes that some listed companies may also be subject to transparency rules in other jurisdictions. The FCA action does not apply to issuers with a home state under the EU Transparency Directive that is not the UK.

The relief does not apply to the publication of preliminary statements of account (known in the market as "prelims"), as these are permitted by the FCA's Listing Rules but not mandated, so there is no deadline to extend. The FCA strongly urges listed companies to consider "whether timetables and practices for financial reporting that were set prior to the COVID-19 pandemic continue to be appropriate in the current circumstances." In particular, the FCA notes that market practice is to release the "prelims" well in advance of the current four-month deadline for publication of the audited statements, and that adverse inferences are drawn if companies delay. On March 21, 2020, the FCA had called on companies to observe a moratorium of at least two weeks on the publication of prelims (which the FCA statement confirms now expires on April 5), pending further action; the Joint Statement is that further action.

The FCA urges listed companies that feel it is appropriate to use the extra two months to do so and urges market participants not to draw undue inferences if companies use the extra time. The FCA statement also clarifies that the two-month extension is intended to temporarily ameliorate challenges "while the UK faces the extreme disruption of the coronavirus pandemic and its aftermath." The FCA will continue to monitor the situation at hand to determine when to end the policy, and commits to announce the end to the policy in a "fair, orderly and transparent way."

The temporary relief does not currently extend to the publication of half-yearly financial reports, which continue to have the three-month deadline under DTR 4.2 (Half-yearly financial reports). As with the timelines for annual reports, the FCA urges listed companies to reconsider their timetables and make use of all of the time available.

The FCA also reminds listed companies that, pending the publication of financial statements, they must continue to consider their obligations under the Market Abuse Regulation ("MAR"), which remains in force, to disclose inside information unless a valid reasons exists to delay disclosure (as permitted by MAR).

In addition, listed companies were given a few other accommodations:

- Delay in the filing of accounts by companies — additional Companies House guidance (available here) permits, upon application, an automatic and immediate three-month extension to deadlines for the filing of accounts for those citing issues relating to COVID-19.
- Postponement of auditor tenders — companies are encouraged to consider delaying planned tenders for new auditors, even when mandatory rotation is due.
- Postponement of audit partner rotation – key audit partners are required to rotate every five years, but this can be extended to seven years given current circumstances, to maintain audit quality.
- Reduction of FRC demands on companies and audit firms – the FRC will, where possible, delay or extend the deadlines for consultations.

FRC Guidance for Companies When Preparing Financial Statements

The FRC, taking into account the market uncertainty surrounding COVID-19, released guidance and a related infographic (available here) to assist companies as they draft public disclosure, prepare their financial statements and face critical decisions. The FRC suggests investors will be focused on five key questions:

- How much cash does the company have?
- What cash and liquidity could the company obtain in the short term?
- What can the company do to manage expenditures in the short term?
- What other actions can the company take to ensure its viability?
- How is the company protecting its key assets and value drivers?

The FRC encourages boards of directors to:

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

The FRC also acknowledges that forward-looking assessments and estimates are particularly difficult to make given current market uncertainties, and its guidance aims to help companies make these judgments as consistently as possible. In this context, as discussed in greater detail below, the guidance covers:

- The need for narrative reporting to publish forward-looking information that is specific and provides insights into the board's assessment of business viability and the methods and assumptions underlying that assessment.
- Going concern and associated material uncertainties, the basis of any significant judgments and the matters to consider when confirming preparation of financial statements on a going concern basis.

- The importance of providing information on significant judgments applied in the preparation of the financial statements, sources of estimation uncertainty and other assumptions made.

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

In particular, boards need to be mindful of:

- ***Information***. Workplace disruptions and shifting resource demands mean new forms of management and control, as well as disruptions to the usual flows of management information. Boards must consider how they can collect and/or complement any missing information as they plan their route through the current emergency towards reactivation of their full business activities. This flow of information will also be important for preparing the published financial statements.

- ***Controls***. Relocation of staff and the inaccessibility of some business locations may lead to risk management processes and internal controls becoming unworkable or otherwise relaxed. Such changes may be unavoidable or considered necessary in the short term to maintain some level of operations. However, the FRC urges boards to monitor such changes carefully, introducing alternative mitigating controls where necessary and practicable to support the operation of an effective control environment.

- ***Capital maintenance***. Assessment of whether a dividend is appropriate should include consideration of current and likely operational and capital needs, contingency planning and directors' legal duties, both in statute and common law. It may be necessary to move funds around a group, using inter-company dividends from subsidiaries to their parent companies or capital contributions between companies.

- ***Reporting***. The board should consider the specific resources, assets and relationships that are most under threat and the steps being taken to protect them. The protection and retention of staff, and the associated institutional memory, may be crucial to the company's ability to meet current challenges and to rebuild when opportunities arise.

- ***Viability statement***. Given the systemic uncertainties that currently exist, many boards will be less confident in stating that they have a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due over a period of assessment. The FRC reminds boards that:

    - they are required to have a "reasonable expectation" of the company's viability over the period of assessment – during the current public health emergency and unprecedented pace of change, any reasonable level of expectation naturally would carry a much lower level of confidence;

- being clear on the company's specific circumstances and the degree of uncertainty about the future is important; and

- when presenting a company's viability statement, boards should draw attention to any qualifications or assumptions as necessary. In describing any qualifications to the statement, boards should describe the limits of the predictions, the level of confidence with which they have been made and the uncertain future events that could prove critical to viability. Similarly, the key assumptions made and the future scenarios considered should be explained.

- ***Going concern***. The FRC believes it is likely that more companies will disclose "material uncertainties" to going concern. When assessing whether material uncertainties exist, boards should consider both the uncertainty and the likely success of any realistically possible response to mitigate this uncertainty. Boards should consider the potential impact of the uncertainties about COVID-19, the extent and duration of social distancing measures, and the impact on the economy and asset prices generally. Boards should pay particular attention to their company's current and potential cash resources, including access to existing and new financing facilities, revolving facilities, invoice discounting and reverse factoring. Access to and use of such facilities should be disclosed appropriately. Boards should also consider access to government support measures that have been announced.

  In addition, the FRC encourages boards to consider the impact of different potential scenarios (e.g., consideration of different time periods for the continuation of social distancing) on the company's revenues, costs (both fixed and variable) and cash flow requirements. If a material uncertainty does exist, then the company should disclose it in terms that are as specific to the entity as possible. Users will wish to know how and when the uncertainty might crystallize and its impact on the resources, operational capacity, liquidity and solvency of the company. If the board concludes that there is not a material uncertainty that meets the criteria for disclosure, but this conclusion requires the application of significant judgment, then this judgment should be disclosed. Providing such disclosures will help meet the information needs of financial statement users to understand fully the pressures on liquidity, viability and solvency.

- ***Judgments and estimation uncertainty***. Companies should disclose significant judgments made in applying accounting policies that have the greatest effect on the financial statements. The requirement to do so is normally distinguished from the requirement regarding sources of estimation uncertainty. The FRC encourages companies to provide as much context as possible for the assumptions and predictions underlying the amounts recognised in the financial statements. Relevant judgments and assumptions might include the availability and extent of support through government support measures that have been announced; availability, extent and timing of sources of cash, including compliance with banking covenants or reliance on those covenants being waived; duration of social distancing measures and their potential impacts.

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

  The FRC notes that there is a general consensus that the outbreak of COVID-19 was a non-adjusting event for the vast majority of UK companies preparing financial statements for periods ended December 31, 2019. Companies will need to judge how much of the impact of COVID-19 should be considered to arise from non-adjusting events for subsequent reporting dates. This will be highly dependent on the reporting date, the specific circumstances of the company's operations and the particular events under consideration. If an event is considered to be non-adjusting, then the nature of the event should be disclosed. Where an estimate of the financial effect can be made, this should be disclosed; otherwise the fact that the financial effect cannot be estimated should be disclosed. The estimate does not need to be exact – a range of estimated effects is better than no quantitative information at all. In the absence of any quantitative estimate, a qualitative description should be provided.

Guidance for Auditors

The FRC has provided practical recommendations on carrying out audit procedures in the face of current obstacles, such as difficulties in obtaining sufficient audit evidence, the consequences of social distancing measures on the audit process, and the challenges posed by market uncertainties. The FRC has provided a non-exhaustive list of factors that auditors should consider as they carry out audit engagements, along with guidance as to how these factors might be addressed. The factors, which should also be considered by listed companies as they plan their audits, include among others:

- ***Materiality***: The impact of the current situation on a listed company may result in non-standard amounts or disclosures being recorded in the financial statements. The auditor may want to consider how to take account of this when setting materiality.

- ***Communications with audit committees***: Physical meetings of audit committees may now be impossible. Auditors will need to agree with audit committees on how to communicate with them through other means, and how to ensure that sufficient time is set aside by audit committees for comprehensive, complete and informed communication with the auditor. This will need to take account of the potential for extended communication necessary to explain any modified audit reports, or to report any higher than expected deficiencies or misstatements, that may result from the current circumstances.

- ***Audit evidence***: Restrictions on travel and mobility will impact the collection of audit evidence. Auditors will need to think about whether there are other ways for them to obtain sufficient, appropriate audit evidence. This might include employing greater use of technology to examine evidence, but only where the auditor has assessed both the sufficiency and appropriateness of the audit evidence produced. The basis for this assessment should be clearly documented.

- ***Compliance with laws and regulations***: Auditors are reminded of their obligations to report a material breach by a listed company of laws, regulations or administrative provisions that lay down, where appropriate, the conditions governing authorization or that specifically govern the pursuit of the activities of the company, a material threat or doubt concerning the continuous functioning of the company, a refusal to issue an audit opinion on the financial statements or the issuing of an adverse or qualified opinion.

- ***Going concern***: The FRC expects, given the current uncertainty and volatility, that more companies and auditors may need to consider reporting on material uncertainties. It also expects that going concern assessments will be more difficult to make, and more companies will need to report a material uncertainty related to going concern. Companies and auditors should explain to investors the effect current public health restrictions in different countries and sensitivities in different short-term scenarios (e.g., the length and nature of public health restrictions that are in place or may evolve during the period of assessment) have on the company's business. Companies and their auditors will need to evaluate whether the company has access to sufficient liquidity and can remain solvent through the period of public health restrictions and beyond. Companies and their auditors also will need to take into account the terms of a company's financing facilities, the terms of any liquidity or other support accessed, and whether any such support taken on gives rise to future obligations. The FRC notes that deferral of payments now, or the receipt of grants to offset costs, may alleviate liquidity challenges but may affect a company's solvency if the liquidity support does not continue long enough for the entity to recoup those losses from future profits.

- Liquidity and solvency risks may be inter-related and either or both may affect going concern status and whether the company faces material uncertainties related to going concern. Auditors will need to ensure that their assessment of going concern, and the evidence they need to gather in support of that assessment, explicitly considers both liquidity and solvency factors, which may affect the ability of the directors to assert that the entity is a going concern and to identify any related material uncertainties.

- ***Group audits***: In the context of group audits, the FRC cited two concerns. Auditors may be unable to obtain sufficient, appropriate audit evidence to support their opinion, for example, because components operate in areas where restrictions apply travel or over access to information. The group auditor should consider what alternative procedures can be implemented to obtain the necessary evidence, including by carrying out additional procedures at the group level to gain assurance, including through greater use of remote work where this is possible, or through deploying staff able to operate in affected jurisdictions in order to provide the group auditor with the necessary evidence. A second challenge may arise where the group auditor is unable to carry out a review of component auditor working papers. Auditors will have to determine whether they can find other ways to review component work, including through remote access, in a manner that is effective. A thoroughly executed and clearly documented electronic and video review of component auditors' work should suffice. Auditors have reporting obligations if they are unable to access information from a component auditor.

- ***Key audit matter***: COVID-19 may well need to be cited as a key audit matter, for example, where it has an effect on overall audit strategy, allocation of audit resources or directing the efforts of the engagement team.
- ***Subsequent events***: Auditors will need to consider what evidence they require to support disclosures of post-balance sheet date events and adjustments made as a result.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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