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A legal update from Dechert's Corporate and Securities Group

Financial Reporting Council Publishes Update for Directors of UK Listed Companies on Responding to Increased Country and Currency Risk in Financial Reports

The Financial Reporting Council[1] ("FRC"), prompted by the current economic uncertainties facing countries around the world, published on 17 January 2012 an update for directors of UK listed companies on responding to increased country and currency risk in financial reports. The update *"aims to draw together a number of the more significant issues directors may reflect when considering how best to provide a balanced and understandable assessment of a company's position and prospects in the context of increased country and currency risk"*. The full FRC update is available at http://www.frc.org.uk/images/uploaded/documents/Update%20for%20Directors%20Jan%2012%20FINAL2.pdf.

Political and economic events (such as: regime changes in the Middle East; funding pressures on certain European countries; austerity measures being adopted across Europe; and the increasing likelihood of one or more countries being forced to leave the Eurozone) are all likely to impact on growth rates and demand for consumer products across Europe. Economic conditions may lead to delays and/or defaults under contracts with trading partners, suppliers and customers and impact upon expectations of future business volumes and margins.

Given the importance of these issues and concern over future developments, analysts and investors will be paying close attention to the risks facing companies. It is therefore critical that directors focus sufficient attention on how the global economic climate will impact on their company and that companies, through their reporting, make clear their potential exposure and to the extent possible explain the steps they are taking to mitigate those risks and manage their exposure.

The FRC update is not intended to be comprehensive or prescriptive but is instead intended to provide a stimulus to directors and audit committees to consider the relevance of currency and country issues to their company's particular circumstances. Directors should be considering these issues on a regular basis and determining whether they should be updating the market, as events develop, outside of their regular reporting cycle.

The FRC's list of the issues which directors could consider is:

- The company's direct exposure to country risk through both financial instruments and exposure to trading counterparties (customers and suppliers). Directors could also consider indirect exposure to such risks, although the FRC update acknowledges that it may not be practical for companies to assess all indirect exposures.
- The impact of austerity measures being adopted by certain countries on issues such as the company's forecasts, impairment testing and going concern considerations, together with the possible consequences of currency events that are

[1] The FRC is the UK's independent regulator responsible for promoting high quality corporate governance and reporting to foster investment. It sets standards for corporate reporting and actuarial practice and monitors and enforces accounting and auditing standards and it also oversees the regulatory activities of the actuarial profession and the professional accountancy bodies.

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not factored into forecasts but may impact reported exposures and sensitivity testing of impairment or going concern considerations.

- Whether any enhanced disclosures may be required in relation to post balance sheet events to avoid misleading investors.

The update also includes examples of how a company's legal and regulatory reporting requirements could be affected by the current economic situation although it is important that directors bear in mind the overarching requirement that the company's financial statements give a true and fair view.

As a general matter the FRC suggested that whilst different legal and regulatory requirements may result in relevant disclosures appearing in different sections of both annual and interim reports (as set out in the FRC examples below), companies should consider whether it may be helpful if the relevant disclosures are consolidated in a single section of reports so that the various effects and risks of the global economic crisis, as they relate to the company, can be more easily appreciated and understood.

UK Corporate Governance Code – Overall Position and Prospects

The UK Corporate Governance Code (the "Code"), also published by the FRC and last updated in June 2010, requires directors of listed companies to provide a balanced and understandable assessment of a company's position and prospects. Companies subject to the Code are required to comment specifically on how risks affecting the company will impact on its business model and whether there are risks to it continuing as a going concern.

Listing Rules, IFRS and UK Companies Act 2006 – Going Concern

The Listing Rules[2] require directors of companies listed on the Official List of the London Stock Exchange to make certain disclosures regarding going concern — these disclosures may need to be reviewed and enhanced. In addition, s417(3)(a) of the UK Companies Act 2006 and IFRS require directors to describe the principal risks and uncertainties facing their business and to make an assessment of the company's ability to continue as a going concern. In their 2011 Annual Report, the Financial Review Reporting Panel[3] expressed the view that these disclosures should include an explanation of the actions taken by the company and processes adopted to mitigate the effects of those risks and uncertainties.

Where a company is significantly exposed to increased country and currency risks, directors may need to enhance disclosures and give an explanation of the steps they have taken or propose to take to mitigate those risks.

Impairment of Financial and Non-Financial Assets

IFRS contains specific requirements to test and assess financial and non-financial assets for impairment.

A material exposure to adverse changes in country and/or currency risk is likely to trigger an impairment assessment for material non-financial assets which are affected by that exposure at each interim and annual reporting date in order to comply with IAS36.

IAS39 identifies a set of potential triggers for when an impairment assessment on financial assets should be undertaken.

Concentration of Risk and Risk of Change in Carry Amount of Assets and Liabilities

In order to comply with IFRS 7, which requires detailed disclosure about concentration of risk as well as detailed disclosure of credit risk, liquidity risk and other market risks, the update recommends that directors should apply judgement to identify those concentrations of risk and describe the circumstances of the company which would need to be taken into account.

If there is a significant risk that there could be a material change in the carrying amount of an asset or liability within the following 12 months then that fact should also be disclosed.

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2 Listing Rule 9.8.6R(3).

3 The Financial Reporting Review Panel is a part of the FRC which seeks to ensure that the provision of financial information by public and large private companies complies with relevant accounting requirements.

Conclusion

In summary, whilst the FRC has not imposed any new requirements or changed companies' reporting obligations, the update will be helpful guidance for directors of companies navigating their way through difficult economic conditions. It will be of particular help to audit committees who will be likely, the FRC note, *"to want a detailed understanding of country and currency risks facing the business, even if only to review the steps taken to identify the material risks. For material exposures [audit committees] are likely to want a full understanding of how those risks have been identified, assessed and managed, their impact on the carrying amount of assets and liabilities reported in the annual/interim reports and how sensitive those carrying amounts are to reasonably possible changes in the estimates and assumptions used by management when preparing the annual report".*

Overall, in encouraging full disclosure by companies, the FRC are reinforcing the message that companies have the opportunity to manage the risk that markets misunderstand their exposures by ensuring that companies explain clearly their relevant material risks and how management is mitigating them and encouraging companies to keep the market up to date as the economic situation develops.

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