Hogan Lovells

FCA, FRC, PRC and ESMA announce measures to alleviate impact on listed issuers and their auditors in response to COVID-19

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The Financial Conduct Authority (FCA), Financial Reporting Council (FRC), Prudential Regulation Authority (PRA) and the European Securities and Markets Authority (ESMA) have announced a series of actions to ensure information continues to flow to investors and support the continued functioning of the UK's and Europe's capital markets. The FCA, FRC and PRA strongly encourage investors, lenders and other users of financial statements to take into account the unique set of circumstances arising from COVID-19 which might result in uncertainty in companies' financial positions, potential delays in the provision of financial information, the need for auditors to undertake additional work to support their audit opinions and the increased use of modified audit opinions, including qualifications arising from scope limitations. ESMA make a similar acknowledgement in their announcement today.

The key takeaways from the announcements are the following:

- a key focus of all those bodies is on the quality of the disclosures that companies make
- accordingly, the FCA will allow London listed companies an extra two months to publish their annual financial reports
- ESMA similarly expects EEA regulators not to prioritise enforcement action against issuers for delaying annual financial statements by two months and half-yearly financial statements (for periods ending before 1 April) by one month
- the FCA's recent request for listed companies to delay publication of preliminary annual results will end on April 5
- the FCA's approach is not a complete solution for issuers with securities admitted to regulated markets in the EEA who are still, for the moment, subject to a four-month deadline in those other markets
- the FCA's approach is not a solution to contractual issues that late filings might cause

- companies will have to continue to comply with Market Abuse Regulation (MAR) and put out inside information to the market as soon as possible, subject to any already existing ability to delay – this is an area where quality and timeliness continues to be of paramount importance
- the need for listed companies to focus on their systems and controls so they have a proper handle on the information needed for an orderly operation of the market
- the need for specificity of the information that companies make public, with generic disclosure being discouraged and more information about judgements and assumptions being encouraged
- an acknowledgement that a Board's need to have a "reasonable expectation" of the company's viability will naturally be underpinned by a much lower level of confidence in the current environment than would normally be the case
- previous market practices relating to the timing and content of financial information and the audit work that is done must change and it is likely that there will be:
    - modified audit opinions where auditors have been unable to gather the necessary audit evidence to complete the audit in full: for example, by limiting the scope of the audit opinion
    - more audited financial statements that include disclosures that management is aware of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern
    - changes to timetables for publication of financial information that had been set before the full implications of coronavirus were clear
- what seems to be firm encouragement to PRA regulated lenders to waive covenant breaches that relate to the coronavirus crisis rather than borrower specific issues.

How should listed companies receive these announcements?

The FCA and ESMA announcements:

The FCA believes that the moratorium it recently declared for companies to delay making preliminary results announcements has been well-observed and that it has given companies with pre-scheduled results announcements the opportunity to absorb recent events and give them due consideration as they prepare their disclosures. The FCA continues to believe that the practice of issuing financial statements earlier than required will add unnecessarily to the pressure on companies and the audit profession at this moment. Accordingly, the FCA is giving London listed companies (debt and equity) an extra two months to publish audited annual financial statements. The FCA acknowledges that the coronavirus pandemic is causing companies of all types to re-think and re-plan almost all aspects of their business and operations. It recognises that some companies, given the nature of their operations, may feel it appropriate to maintain the four-month calendar, but it also urges all those companies that feel it appropriate to utilise the additional two months to do so. It also sends a message to investors – it urges them and other market participants not to draw undue adverse inferences when companies make use of the extra time the FCA's temporary relief gives them since, for a great many companies, it will be sensible to do so in these unprecedented times.

As we have said before, MAR remains in force and companies must continue to assess carefully what information constitutes inside information, recognising that the pandemic and policy responses to it may alter the nature of information that is material to a business's prospects.

One of the biggest challenges for companies will be to reconcile, on the one hand, delaying disclosure of financial information (either preliminary financial information in accordance with the FCA's moratorium which ends on April 5 or the audited annual financial statements in accordance with this latest announcement), and on the other hand, disclosing inside information to the market as soon as possible. There is always a challenge when a company is completing the preparation of annual or interim financial statements as to whether any of the information which it acquires in the course of their preparation constitutes inside information, which would need to be announced. That is likely to be even more pronounced in a situation such as this where the company is working with the auditors to give them the comfort they need before the final audited financial statements can be published. Companies may turn to qualitative disclosure, unaudited data that updates previously published data or other forms of guidance prior to the publication of the audited financial statements to help update the market on the state of play. Companies should in any event look at the FRC graphic included below as a guide to what investors have said they expect by way of disclosures.

Given that the announcements of the FCA and ESMA are in respect of enforcement action against tardy issuers rather than an announcement of a change in the underlying rules, listed issuers will need to think about whether they are in breach of contractual obligations requiring compliance with the listing rules and Transparency Directive. Separately, companies will also need to think about what waivers are needed in credit agreements and bond documents that require the delivery of audited annual and unaudited interim financial statements. The PRA's statement regarding the non-enforcement of covenants may help.

ESMA further encourages EEA regulators to generally apply a risk-based approach in the exercise of supervisory powers in their day-to-day enforcement of deadlines in respect of financial reports. This opens the way for leniency beyond the time periods specified by ESMA. We would expect the FCA to take a similar approach even if they have not expressly said this in their announcement. Compliance with MAR is likely to be even more critical for these issuers. ESMA also expressly states that they expect issuers to inform their regulators of any delay beyond the four and three month deadlines for annuals and interims and explain to the market the reasons for the delay and to the extent possible the estimated publication date. We would expect London listed issuers to take a similar approach with the FCA and the market.

The FRC announcement:

The FRC acknowledges the challenges for companies and auditors to work together for companies to produce audited accounts and provides auditors with guidance on what is expected of them. What is clear from the FRC guidance is that while companies and their auditors might be cut some slack in terms of timing, the exacting standards for financial information and its audit remain intact. Accordingly, the focus of the FRC appears to be in encouraging Boards to bring to bear strong systems and controls to deliver quality information, and giving the auditors the time to explore the underlying evidence, perhaps by different means given the challenges in obtaining physical access, to reach the required level of comfort for the issuance of a clean audit opinion.

Some key issues they highlight for companies include the following:

- the need for narrative reporting to provide forward-looking information that is specific to the entity and which provides insights into the Board's assessment of business viability and the methods and assumptions underlying that assessment

- the increased importance of providing information on significant judgements applied in the preparation of the financial statements, sources of estimation uncertainty and other assumptions made
- the judgement required in determining the appropriate reporting response to events after the reporting date and the extent to which qualitative or quantitative disclosures may be appropriate.
- the need for Boards to develop and implement actions and processes to ensure an effective control environment, in particular, adapting key reporting and other controls to the current environment
- the need for Boards to consider how they will secure reliable and relevant information to manage their operations and those of their workforce and suppliers, including the flow of financial information from affiliates, not least taking into account blockages that may have arisen in communications channels that were operating well before the coronavirus crisis
- the need for Boards to focus on capital maintenance to ensure enough reserves are available when a dividend is paid, not only when it is proposed or declared, taking into account their fiduciary duties and obligations under the Companies Act.
- 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 viability statement required for compliance with the UK Corporate Governance Code. In this context, the FRC stressed the following points:
  - Boards are required to have a “reasonable expectation” of the company’s viability over the period of assessment – during the current emergency and unprecedented pace of change, any reasonable level of expectation would naturally carry a much lower level of confidence. Acknowledging this, we believe, was an important step for the FRC to help Boards
  - being clear on the company’s specific circumstances and the degree of uncertainty about the future is important information
  - when presenting a company’s viability statement, the Board should draw attention to any qualifications or assumptions as necessary.
- The importance of the interrelationship between the timing of the outbreak of COVID-19 and the balance sheet date as to whether it requires quantitative adjustment to financial information or narrative disclosure about it as a material non-adjusting event, supplemented by disclosure of the financial effect if estimable. The FRC acknowledges the consensus that it should not be a quantitative adjusting event for the vast majority of UK companies reporting on a calendar year basis.
- the impact of the coronavirus crisis likely requiring auditors to revisit their risk assessment and the proposed response to identified risks
- more extensive auditor going concern work and an increase in the number of companies reporting a material uncertainty related to going concern
- a reminder that where an auditor cannot obtain sufficient appropriate audit evidence, then the auditor is required to modify their opinion in that respect. Where the possible impact on

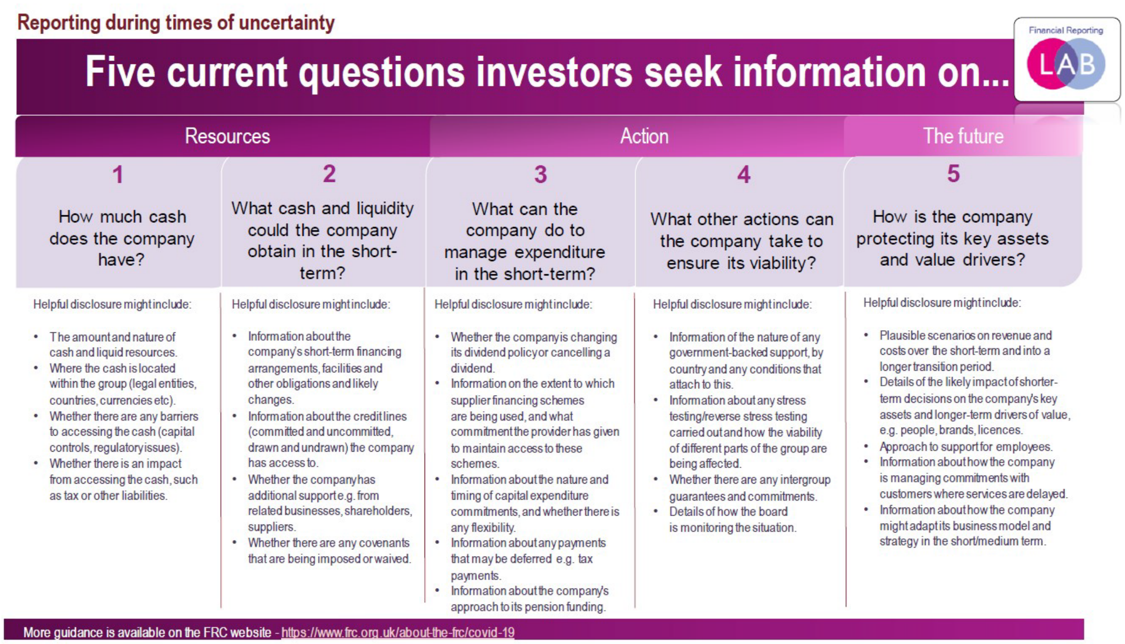
the financial statements could be both material and pervasive, then the auditor is required to disclaim their opinion or if it is material but not pervasive, to express a qualified opinion.

- a sobering reminder that misstatements in financial statements may arise due to the application of the going concern basis of accounting when it is not appropriate; the omission of disclosures about a material uncertainty relating to going concern; or a failure to recognise adequate impairment of assets or adequate provisions for obligations or to provide related disclosures

- a reminder that when an auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements are material, the auditor is also required to modify their opinion in that respect. When the effect of such misstatements is both material and pervasive, the auditor is required to express an adverse opinion.

In addition, the FRC highlights the clear reality that the market faces an unprecedented level of uncertainty about the economy and consequent future earnings of companies over the next 12 months. They acknowledge that it is difficult to make a meaningful base case economic forecast, let alone a plausible downside economic scenario.[1] In this highly uncertain environment, they say, going concern assessments will be more difficult for entities to make, and more companies will need to report a material uncertainty related to going concern. The FRC states that companies and auditors should explain to investors the effect on their business of the current public health restrictions in different countries, sensitivities in different short-term scenarios, for example the length and nature of public health restrictions that are in place or may evolve during the period of assessment.

Helpfully, the FRC includes a graphic that summarises the findings of its Financial Reporting Lab which has been seeking feedback from investors on the disclosures that they would like to see:



Source: *https://www.frc.org.uk/about-the-frc/covid-19/frc-covid-19-infographic-mar-2020*

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[1] This stark statement from the FRC brings into sharp focus the challenges for companies in not only understanding that they can operate as a going concern, but also in developing working capital models in connection with capital raisings. If sponsors are required to give working capital comfort to the FCA for premium listed companies, they will, as is custom, require working capital comfort from reporting accountants. The challenges for companies, reporting accountants and sponsors (and their advisers) in this environment will need careful consideration. In addition, also in the context of capital raisings, the potential challenges for accountants to provide clean comfort to underwriters should also not be ignored. The likely recapitalisations that will come from the coronavirus crisis will need to be thought through with care.

Companies will need to think very hard about what they can meaningfully say to the market on each of these matters. As a baseline, it provides them with a framework around which to try and craft their disclosures.

The PRA announcement:

The PRA has, among other things, provided guidance to lenders on how they should respond to covenant breaches related to coronavirus, as follows:

"[The PRA] would expect lenders to consider the need to 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. [The PRA] would expect firms to do so in good faith and not to impose new charges or restrictions on customers following a covenant breach that are unrelated to the facts and circumstances that led to that breach."

The PRA has also provided guidance to UK banks, building societies and PRA-designated investment firms regarding the application of IFRS9 including the extent to which payment holidays should constitute an event of default or should otherwise attract a lifetime expected loss provision.

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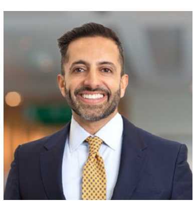

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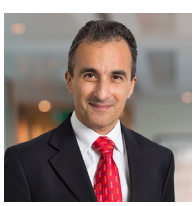

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