

UKLA Primary Market Technical Note

Working capital statements and risk factors

The information in this note is designed to help issuers and practitioners interpret our Listing Rules, Prospectus Regulation Rules, Disclosure Guidance and Transparency Rules, and related legislation. The guidance notes provide answers to the most common queries we receive and represent FCA guidance as defined in section 139A FSMA.

ESMA recommendations, PR Appendix 3 Annexes FCA Guidelines on prospectus disclosure, PR Regulation Annexes

The interaction between working capital statements and risk factors

FCA Guidelines on prospectus disclosure 29-37 Paragraphs 107 to 126 of the ESMA recommendations for the consistent implementation of the Prospectus Directive Regulation (ESMA recommendations) set out detailed guidance on the approach to be used by issuers and their advisers when preparing working capital statements. This includes guidance on when a working capital statement should be provided on a clean basis and when it should be qualified.

Guideline 29 (para 131) states that the working capital statement should be consistent with other parts of the prospectus and that where other parts of the prospectus describe elements that could adversely impact the issuer's ability to meet its present requirements, the issuer should not make a clean working capital statement. Specific reference is made in this context to the risk factor section.

There is clearly the potential for a significant degree of overlap between the risk factors section of a prospectus and the issuer's working capital statement. This potential overlap is recognised in the ESMA recommendations itself –

114. There may be a desire by issuers to disclose assumptions and include potential caveats to the clean statement required by the regulation. The addition of such disclosures will detract from the value of the statement. Detailed disclosure of assumptions that the issuer has made in reaching its opinion, will put the onus on investors to reach their own conclusion regarding adequacy of working capital and are therefore not normally acceptable:

115. In making a clean statement there should therefore be no reference to:

- 'Will have' or 'may have' sufficient working capital, rather than 'is sufficient', 'will have' or 'may have' could for example indicate an unidentified future time or event such as debt facilities yet to be agreed, within the next 12 months.
- Assumptions, sensitivities, risk factors, or caveats. All working capital statements should be made on the basis of reasonable assumptions – disclosure of these only serves to qualify and confuse the statement for shareholders and investors.'

As a consequence of This guidance, which is consistent with the approach the UKLA FCA has historically taken to working capital statements, and we will pay particularly close attention to risk factors that suggest the issuer will or may run out of working

capital in the next 12 months. Where such risk factors sit alongside a clean working capital statement we consider that Guideline 29 ~~the above sections of the ESMA recommendations are directly relevant~~ is clear in its application, and we apply this approach both to prospectuses under the Prospectus Regulation Rules and circulars under the Listing Rules.

Principles we use when assessing risk factors

In applying the ~~ESMA recommendations~~ FCA Guidelines on prospectus disclosure to risk factors in documents with clean working capital statements we will have regard to the following principles:

The document belongs to the issuer and the issuer and its advisors must be satisfied that it discloses the issuer's position accurately

When approaching the question of the interaction of risk factors with an issuer's working capital statement, we see the role of the ~~UKLA~~ FCA to be to challenge an issuer's document where there is inconsistency. We do not consider the ~~UKLA's~~ FCA's role to be redrafting an issuer's risk factors, or seeking to remove risks from a document that are necessary to give investors a fully informed view of the issuer's financial position.

Where a risk factor accurately describes a situation that is fundamentally inconsistent with a clean working capital statement, either the facts underlying the risk factor should be addressed (for example, by securing additional facilities), or the working capital statement should be provided on a qualified basis. It will not be appropriate to simply remove or modify the risk factor (and nor should we ask an issuer to do so) if it would lead to deficient disclosure in the document.

Whether and how a risk should be disclosed is fundamentally a question for the issuer in consultation with its advisers. The role of the ~~UKLA~~ FCA in this context is limited to ensuring the document as a whole (including the issuer's working capital statement) is consistent with the risk factor disclosure. Discussions of risk factors in this context are likely to entail a high level of interaction, and we would ask issuers to ensure there is a meaningful dialogue with us when these issues are being discussed, as this is essential to ensuring that the position is correctly reflected in the issuer's document.

Some risk factors are fundamentally inconsistent with a clean working capital statement

Certain risk factor disclosures cannot be reconciled with a clean working capital statement due to the nature of the risk disclosed. For example, risk factors that state that the issuer may not be able to meet a significant scheduled repayment on its debt financing if its business is not sufficiently cash generative over the next 12 months, or may not be able to access sufficient future sources of funding to meet its requirements, are clear statements that the issuer does not have sufficient

working capital. In this context, paras 13625 and 126 of the ESMA recommendations are of Guideline 30 is directly relevant. Para 13625 explains that the work procedures underpinning a working capital statement should include an 'assessing whether there are sufficient resources assessment of whether there is sufficient margin or headroom to cover a reasonable worst case scenario (sensitivity analysis).' Para 126 explains: It is further explained that:

'126-Where there is insufficient headroom between required and available funding to cover reasonable alternative scenarios, the issuer will need to reconsider its business plans or arrange additional financing if it wishes to provide a clean working capital statement it will not be possible for issuers to make a clean working capital statement. In those circumstances if the issuer is to give a clean statement he will need to reconsider their business plans or to arrange additional financing.'

In circumstances where additional financing is not arranged in this way, there may be no option but to provide a qualified working capital statement. An approach that seeks simply to obscure or dilute the impact of the risk factor through re-drafting, while maintaining a clean working capital statement, will not be appropriate if it leads to a misleading presentation of the issuer's financial position.

Not all risk factors dealing with matters of funding or finance are necessarily inconsistent with a clean working capital statement

Risk factors may disclose risks regarding an issuer's financing or funding structure without necessarily being inconsistent with a clean working capital statement. For example, a risk factor that highlights that covenants within an issuer's facilities may limit its scope for expansion or force it to pass over acquisition opportunities, is not necessarily inconsistent with a clean working capital statement. Similarly, risk factors that highlight that increasing costs of capital may restrict future profitability do not necessarily suggest difficulties with an issuer's working capital position. Such risk factors should, however, be carefully and tightly drafted – the more broadly and generically such risk factors are drafted, the greater the risk will be that they will be interpreted as qualifying the issuer's working capital statement.

The document as a whole should be consistent (Guideline 30, para 131) – the risk factors, business strategy and working capital sections should all tell the same story

There is a clear risk that if a compartmentalised approach is taken to the drafting and vetting of the different sections of the document, an inconsistent picture of the issuer's financial position could emerge. Issuers should aim to present a clear picture of their position that is consistent across the working capital, risk factors and business strategy section. If, for example, the issuer's working capital exercise shows a sufficiency of working capital over the next 12 months, but calls into question the ability of the issuer to expand, make acquisitions, or undertake capital projects as it might have been intending, the business strategy section should be drafted to be

consistent with this. In some cases (for example, mineral or scientific research-based companies) the issuer may be able to adjust its business plan to match its limited working capital. However, in this situation two factors remain very significant:

- Firstly, the document's business strategy section should be drafted in a manner that is consistent with these pared back ambitions.
- Secondly, there is a clear distinction in this context between mitigating actions that are within and without the issuer's control – for example, there is a significant difference between selling an existing division and deciding not to purchase a similar division from a third party. The latter might be consistent with a clean working capital statement, but it is unlikely that the former will be sufficiently certain to satisfy this test.

Some high impact low probability risks may be consistent with a clean working capital statement

There is a small subset of risks that are disclosed only by virtue of the severe impact they would have on an issuer's position should they crystallise. Although highly unlikely to happen, such risks may pass the materiality for disclosure threshold merely because of the severe impact they would have were they to happen. Such risks are often expressed as being terminal for the issuer if they crystallise – clearly in such an eventuality the issuer would also not have sufficient working capital. So long as such risks are sufficiently tightly drafted, and the very high impact/low probability nature of the risk is clearly disclosed, such risk factors are not necessarily inconsistent with a clean working capital statement, provided it is based on reasonable (including stressed) assumptions. However, such risks are likely to form a very small minority of cases and/or to exist only during periods of acute economic or market disruption, and should not be broadened into a more general risk that starts to call into question the issuer's general working capital position.

Risks should only be expressed to operate “in the longer term” if this is genuinely the case

A number of risk factors are expressed in terms that suggest that the risk only operates either 'in the longer term' or after the period covered by the 12 month working capital statement. While this might be true of a small minority of risks (for example, the risk of not meeting a debt repayment scheduled for 18 months time), it is unlikely that this will be true in the majority of cases. Nor should such wording simply be used as a way of taking the risk factor outside the strict 12 month period of the working capital statement and so removing any potential for overlap with a clean statement. Where this wording is used, we will accordingly question the disclosure to ensure the risk is still appropriately and accurately described.

Risk factor sections should be particular to the issuer and should detail a specific risk

Risk factors should be prepared with regard to the Guidelines on risk factors under the Prospectus Regulation. Accordingly, Risk factors should be specifically drafted for the issuer and issue concerned, and should not be either generic or seek merely to track risk factors included in other documents issued by other issuers or previously by the same issuer. Nor should risk factors simply be statements of fact that do not detail a particular risk. Each risk factor should identify and disclose a specific risk that is relevant for the issuer and issue concerned rather than simply disclosing generic or boiler-plate risks. The particular risk should also be disclosed and described in as concise or precise focused a manner as possible.

Often difficulties arise either because an issuer is seeking to cover in its document all conceivable risks irrespective of their actual materiality, or because a genuine risk has been drawn far too broadly or generically, and so starts to stray into areas that overlap with an issuer's working capital statement.

Risk factors cannot be made to be consistent with a clean working capital statement simply by using disclaimers or preambles

Our view is that the facts and risks disclosed by a particular risk factor are either inherently consistent or inconsistent with a clean working capital statement. If they are inconsistent then this cannot be remedied through the use of a disclaimer or preamble that states the risk factor is not intended to qualify the issuer's working capital statement. Any such disclaimers will be ignored when we assess the interaction of the risk factor with the issuer's working capital statement.