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Our ref: ICAEW Rep 34/14

Your ref:

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By e-mail to riskreview@frc.org.uk

Dear Catherine

Risk Management, Internal Control and the Going Concern Basis of Accounting

ICAEW is pleased to respond to your request for comments on the consultation paper referred to above.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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ICAEW REPRESENTATION

RISK MANAGEMENT, INTERNAL CONTROL AND THE GOING CONCERN BASIS OF ACCOUNTING

Memorandum of comment submitted in February 2014 by ICAEW, in response to the Financial Reporting Council's consultation paper *Risk Management, Internal Control and the Going Concern Basis of Accounting* published in November 2013

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INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the consultation paper *Risk Management, Internal Control and the Going Concern Basis of Accounting* published by the Financial Reporting Council on 7 November 2013, a copy of which is available from this [link](#).

WHO WE ARE

2. ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 142,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.
3. ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.
4. In preparing our response, we have sought input from individuals drawn from the full breadth of our membership, including listed company directors and audit committee members, audit practitioners and consultants in public practice, internal auditors and institutional and private investors. ICAEW also expects to apply the proposed new guidance to its own business and in its own public reporting.

MAJOR POINTS

Developments we support in principle

5. We support the idea of linking the going concern assessment to existing processes for assessing risk and internal control. This should help to ensure that the going concern assessment reflects the board's best knowledge of a company's risks and related responses and is not treated as an add-on exercise at the end of the year. We also welcome the limitation of the term 'going concern' to consideration of the going concern basis of accounting and the establishment of a broader and more long term assessment of solvency and liquidity risks.
6. We also agree that it is time to refresh the FRC's 'Internal Control - Revised Guidance for Directors on the Combined Code' (2005) ('Turnbull'), to ensure that it reflects up-to-date thinking about risk and internal control, and the guidance for directors on 'Going Concern and Liquidity Risk' (2009). The current Turnbull guidance needs to reflect changes made to the related parts of the UK Corporate Governance Code in 2010 and experience gathered by the FRC in 2010 and 2011 and summarised in its Board and Risks paper. The FRC's going concern guidance needs to reflect the results of the Sharman Inquiry and experience gathered in recent harsh economic conditions.

Need to manage the challenge of developing guidance which can be successfully implemented

7. While we support in principle the FRC's direction of travel, we are conscious of the challenge of developing pronouncements on internal control and related topics which achieve their intended purpose. It took until 1999 before the Turnbull guidance was issued to support implementation of the relevant part of the 1992 Cadbury Code after earlier guidance had failed to gain acceptance in the business community. The limited revision of the Turnbull guidance in 2005 was only issued after painstaking consultation and engagement with business.

8. While the FRC began its work on the current revision of the Turnbull guidance in 2010, there was a two year quiet period before the current consultation paper was issued on 6 November 2013. The Christmas and New Year holiday season and the demands of December financial year-ends mean that few businesses have had the opportunity to think through the practical implications of the FRC's proposals. In our response we highlight a number of areas which require careful consideration if the FRC is to conclude that the revised guidance will have a positive overall impact.
9. In the present consultation the proposed changes to the UK Corporate Governance Code and Auditing Standards are presented in mark-up whereas the guidance itself is a rewrite. It is hard to identify the major changes in behaviours that are expected of boards as a result of the proposed revised guidance (see paragraphs 21 and 24 of this letter). Because the Turnbull guidance has been stable for a long period, it is embedded in company processes. Companies are not starting with a blank piece of paper; they need to know what has changed in the new guidance. It would be unfortunate if companies had to invest significant management and board time and incur significant professional fees to work out what the new guidance is trying to achieve and how to implement it. A mark-up showing what changes have been made to the existing guidance would therefore help boards understand the changes which the new guidance seeks to implement and demonstrate how it fits with the finding in Boards and Risk that the Turnbull Guidance requires only a 'limited review' (see paragraph 23 of this letter). Furthermore, a regulatory impact assessment for the draft revised guidance would have been helpful for boards to understand the areas which, in the FRC's judgement, are most likely to require changes to their existing processes.
10. One area where it is clear that the FRC expects change is in the quality of disclosure around remedial action to address failings and weaknesses. However, here the FRC needs to be confident that the proposed guidance can deliver change in the absence of any criteria for identifying significant failings and weaknesses that call for disclosure. We propose an alternative approach in paragraph 34 of this letter.
11. Achieving a successful implementation will require reflection on the comments received as a result of the consultation process and engagement with a wide range of stakeholders to ensure that conflicting views and practical issues can be dealt with effectively. We doubt whether this process can be completed within the target date for issuing the guidance of the first half of 2014.
12. To allow time to road test and refine the guidance, the FRC might simply want to proceed in the short term with making its proposed changes to the UK Corporate Governance Code. However, in this respect we are concerned that the removal of code provision C.1.3 which requires a going concern statement might send an unfortunate headline message that there are reduced expectations of boards (see paragraph 57 of this letter).

Challenges of combining Turnbull and going concern guidance

13. Integrating the going concern guidance into the Turnbull guidance is a challenging exercise, given the fundamentally different nature of the documents. We agree that in assessing the risks that might be material uncertainties in applying the going concern basis of accounting, it is reasonable to expect boards to consider the same risks that have been assessed under the company's risk management and internal control process. However, we are not convinced that the draft revised guidance manages successfully to combine the requirements for assessing risk management and internal control with the guidance for determining whether it is appropriate to adopt the going concern basis of accounting (see paragraph 25 of this letter).
14. It may be more appropriate to maintain a separate document for going concern which could retain within it useful features of the current guidance on decision making and disclosure and to cross-refer to it from the guidance on risk management and internal control. The latter could therefore retain its present Turnbull look and feel as a short principle-based document aimed at directors. Such an approach may have the added advantage of obviating the need to

produce a separate guidance document for non-Code companies on going concern, although this should only be done after a proper impact assessment to ensure it is appropriate for non-Code companies (see paragraph 26 of this letter).

15. In practical business terms we are also concerned that the proposed revised guidance might be seen as integrating the consideration of risk and going concern by presuming that an assessment of solvency, liquidity or going concern should begin with an attempt to capture all the risks that might give rise to severe distress before considering what information is available about the future. Boards should still be able to begin their assessment of going concern with forecasts and budgets that are based on an understanding of the business and its plans. These can then be tested for their robustness to downside risks by drawing on risk analysis that results from the company's risk management and internal control processes (see paragraph 39 of this letter).

Issues related to principal risks

16. The concept of 'principal risk' is central to the draft guidance and replaces that of 'significant risk'. While this change aligns the Code and the related guidance with the Strategic Report it would be helpful to clarify whether the terms are intended to be equivalent. People would generally understand 'significant' to be an absolute term with the consequence that riskier businesses would generally have a greater number of significant risks, whereas 'principal' is a relative term with the consequence that all businesses would have a similar number of principal risks. The various explanations of the term principal risk seem to favour an absolute rather than a relative interpretation. We welcome this and think that the guidance should be explicit that principal risks have to be significant in themselves and not merely the most important risks relative to the total population of risks facing a company (see paragraph 56 of this letter).
17. As the board is required to describe the principal risks of the company in the Strategic Report, it is vital that the draft revised guidance provides a clear, single definition of principal risks in order to help the board focus its assessment of risks on the right population of risks. We find references to principal risks confusing. It is unclear to us whether the FRC, in paragraph 25 of the draft revised guidance, intends likelihood, impact, the availability of mitigating actions and the likelihood of those actions being effective to be part of the definition of principal risk or whether there is some other way of identifying which risks are principal risks and the board is then required to evaluate likelihood, impact and mitigating actions. Furthermore, paragraph 26 appears to define principal risks in a way that makes reference only to impact. This definition is different from what is suggested in paragraph 25 and would include risks with very low likelihood or for which there are mitigating actions which are felt to be highly effective (see paragraphs 27-30 of this letter).
18. Finally, the draft revised guidance refers to 'principal solvency and liquidity risks' in a way that does not make it clear whether these are intended to be a subset of principal risks or whether they are a separate category of principal risks. As with all our requests for clarity, we are concerned that failure to address them will result in boards delegating responsibility to others to interpret what needs to be done to comply with the guidance.

Other implementation issues

19. In addition to the major points raised above, we have the following concerns:
 - we do not think it appropriate for the FRC to provide its own interpretation of IFRS (paragraph 45 of this letter);
 - we think that helpful cross-references on going concern disclosures which are found in the existing guidance but not in the new guidance should be reinstated (paragraph 36 of this letter); and
 - we think it may prove difficult in future for boards to adopt a single process to satisfy UK and SEC requirements, and this will have cost implications (paragraph 37 of this letter).

RESPONSES TO SPECIFIC QUESTIONS

20. Questions are highlighted in bold text throughout the consultation paper. For ease of reference, we have numbered the questions sequentially from Q1 to Q9 and identified the page on which they appear.

Q1 – page 3: The FRC would welcome views on whether the draft revised guidance achieves these objectives [to address in more depth how the board should fulfil its responsibilities to consider the nature and extent of the risks facing the company; the extent and categories of risk which it regards as acceptable for the company to bear; the likelihood of the risks concerned materialising; the company's ability to reduce the incidence and impact on the business of risks that do materialise; and the costs of operating particular controls relative to the benefit thereby obtained in managing the related risks] and on the structure of, and level of detail in, the draft revised guidance

21. We have struggled to identify the major changes that the draft revised guidance is expecting boards to make in respect of the guidance's broad objective of addressing the board's responsibilities for internal control and risk management 'in more depth'. Different people reading the revised guidance read different things into it. In attempting to identify the key purpose for updating the guidance, some suggest that it is to encourage boards to give greater consideration to 'black swan' risks, while others think it is to anchor the board's processes in the disclosure of principal risks in the Strategic Report or in the disclosure of remedial actions taken to correct significant failing or weaknesses. In addition, some think that the draft revised guidance now requires the going concern assessment to be undertaken on a continuous basis, rather than twice a year (see also paragraph 57 of this letter). In the absence of a common understanding of what the guidance is seeking to achieve, it is difficult to be confident that its objectives will be achieved.

22. Our understanding is that the reasons for updating the Turnbull guidance are to:

- reflect actual and proposed changes to the UK Corporate Governance Code since 2005;
- incorporate views sought by the FRC from directors, investors and advisers as summarised by the FRC in *Boards and Risk* (2011); and
- integrate the going concern and liquidity risk guidance of 2009, taking into account the recommendations of the Sharman Inquiry.

23. The main findings of *Boards and Risk* were that:

- there has been a step change in the board's focus on risk, conforming with the 2010 changes to the Code to emphasise the board's responsibility for strategic risk decision-making;
- the 2005 Turnbull guidance remained broadly fit for purpose, but there would be some benefit in updating it to reflect the change in role of the board; and
- the approaches and techniques used by boards in assessing and managing risk have been developing rapidly, and there is value in sharing best practice more widely in a way that makes it clear that it is meant to be helpful, not mandatory.

24. We cannot identify how the draft revised guidance expects the board to demonstrate its responsibility for strategic risk decision-making under the 2010 changes to the Code. While Section 1 of the draft revised guidance sets out a summary of changes to the Code, the sources of guidance which the draft revised guidance seeks to replace and other sources which it is reflecting, it is unclear what behavioural changes the draft revised guidance is designed to bring about. There is a gap between, on the one hand, the consultation paper proposals and, on the other, what the FRC describes as 'high profile failures of risk management in recent years' (paragraph 3, page 1) and 'a step change' in the board's focus on risk, as identified in *Boards and Risk*. For example, *Boards and Risk* makes it clear that an awareness of 'black swan' risks (ie, high impact, very low probability risks) is welcomed but that this should not be at the expense of addressing more 'traditional' risks. The draft revised guidance does not explain whether the FRC is expecting boards to act differently in respect of black swan risks.

25. Integrating the going concern guidance into the Turnbull guidance is a challenging exercise, given the fundamentally different nature of the two documents. We agree that in assessing the risks that might be material uncertainties in applying the going concern basis of accounting, it is reasonable to expect boards to consider the same risks that have been assessed under the company's risk management and internal control process. However, we are not convinced that the draft revised guidance manages successfully to combine the requirements for assessing risk management and internal control with the guidance for determining whether it is appropriate to adopt the going concern basis of accounting.
26. It may be more appropriate to maintain a separate document for going concern which could retain within it useful features of the current guidance on decision making and disclosure and to cross-refer to it from the guidance on risk management and internal control. The latter could therefore retain its present Turnbull look and feel as a short principle-based document aimed at directors. Such an approach may also obviate the need to produce separate going concern guidance documents for Code and non-Code companies, although this should only be done after a proper impact assessment to ensure it is appropriate for non-Code companies.

Q2 – page 3: Do you agree [that sections 2 to 4 of the draft revised guidance, which elaborate on the references in the current guidance, and respectively address the board's responsibilities for managing the principal risks facing the company, the factors that boards should consider in order to exercise those responsibilities effectively, and how risks are assessed, and sections 5 and 6 of the draft revised guidance, which are largely unchanged from the current guidance, are fit for purpose,] or are more substantive changes to these sections required?

27. The concept of 'principal risk' is central to the guidance and we find it difficult to understand. Paragraph 25 states 'The board should identify the principal risks facing the company and evaluate the likelihood of their incidence, and their impact if they were to materialise. It should assess the availability and likely effectiveness of actions that it would consider undertaking... to avoid or reduce the impact of the underlying risks.' It is unclear to us whether the FRC intends likelihood, impact, the availability of mitigating actions and the likelihood of those actions being effective to be part of the definition of principal risk or whether there is some other way of identifying which risks are principal risks and the board is then required to evaluate likelihood, impact, the availability of mitigating actions and the likelihood of those actions being effective for each such principal risk.
28. Furthermore, paragraph 26 requires boards to treat 'risks or combinations of risks that can seriously affect the future performance, solvency or liquidity of the company, irrespective of how they are classified or whether they stem from failures of strategy, operations, organisation or behaviour, or from external factors over which the board may have little or no direct control' as 'principal risks'. This appears to define 'principal risks' in a way that makes reference only to impact. This definition is different to what is suggested in paragraph 25 and would include risks with very low likelihood or for which there are mitigating actions which are felt to be highly effective. The basis on which boards would identify combinations of risks as constituting principal risks is also unclear. The potential for an unhelpful proliferation of principal risks needs to be addressed.
29. Paragraph 29 states 'In evaluating the impact of principal risks materialising, the board should consider the sufficiency of the company's risk management processes and internal controls and contingency plans, and be clear about the extent to which there are residual risks even where these are operating effectively.' We do not understand the objective of this paragraph. For many risks, the company's risk management and internal control process will focus on ensuring that the risk does not materialise. In these cases, the impact of the risk materialising already presumes that the company's risk management and internal control process are not effective.

30. Paragraph 30 states ‘The board should specifically consider the principal solvency and liquidity risks and other risks that would so seriously affect the company’s cash flows, performance or future prospects that they would give rise to severe distress if they were to materialise.’ We are unclear whether the FRC intends principal solvency and liquidity risks to be an additional category of principal risks or whether the risks to be considered in paragraph 30 are only those that are already considered to be principal risks. In addition, because paragraph 30, like paragraph 26 of the draft revised guidance, makes reference only to impact, it would appear to classify as ‘principal solvency and liquidity risks’ risks with very low likelihood or for which there are mitigating actions which are judged to be highly effective.
31. As we note in answering Q4 below, we think it would be helpful for the guidance, in particular Section 6, to cross-refer to Appendices D and E and how they are intended to be used by boards in assessing effectiveness.

Q3 – page 4: The FRC would welcome views on [the] proposed change to the guidance [to recommend more explicitly that the board should ‘explain what actions have been or are being taken to remedy any significant failings or weaknesses identified from that review’]

32. While we support the intention of improving transparency that lies behind this proposed change, we oppose it on the grounds that it is unlikely to succeed in the absence of criteria for identifying significant failings or weaknesses. International experience indicates that it is difficult to define concepts such as material weakness even when the scope is limited to internal control over financial reporting rather than the broader scope covered by the FRC’s guidance. Failings or weaknesses that had given rise to a financial statement impact, such as a loss due to fraud, would already have been reflected in the financial statements, and boards would already be required to explain them in more detail where their financial statement impact was significant. However, some failings or weaknesses might be considered by users to be qualitatively significant even where the actual financial loss is small or non-existent and different users will have different attitudes to determining significance in these circumstances.
33. We are also not convinced that a significant weakness in internal control is always a sufficient trigger for disclosure. It is unclear what benefit will be gained from disclosing significant weaknesses that have been identified and fixed before they resulted in a significant failing with a financial statement impact.
34. An alternative approach could be to propose that boards have regard to operational and financial matters disclosed in the financial statements, elsewhere in the annual report and in other public reporting that might reasonably raise questions in the minds of users of that information about the effectiveness of risk management and internal control. Boards should then provide information on how the risk management and internal control implications of those matters have been or are being addressed. This would address the FRC’s concern about a lack of meaningful disclosures about remedial actions and provide a basis for investors and others to expect better reporting, while avoiding a theoretical and compliance-driven debate about what constitutes a significant failing or weakness.

Q4 – page 4: The FRC would welcome views on whether [Appendices A, D and E] are of use to directors and, if so, how they might be improved. [Appendices B and C are dealt with specifically below]

35. Overall, we did not find the appendices useful. The objectives of each appendix are unclear and we are uncertain how users of the draft revised guidance are intended to use the appendices as Appendices A, D and E are referred to only in the Introduction. We provide more detailed comments on each appendix below.
36. Appendix A provides cross-references to requirements within the UK Corporate Governance Code, the Companies Act 2006, Disclosure and Transparency Rules, the Listing Rules, IFRS and regulatory requirements. Such cross-references are not provided in the Turnbull Guidance. A cross-reference to legal and regulatory requirements in relation to going concern

is provided on pages 12-17 of Going Concern and Liquidity Risk, although in significantly more detail than has been provided within Appendix A. We can see value in providing comprehensive cross-referencing to legal and regulatory requirements for risk and going concern disclosures, but we suggest that it is located outside the guidance to avoid clutter and to allow it to be updated as and when legal and regulatory requirements change without precipitating an update of the guidance itself. ICAEW would be happy to assist the FRC in preparing and maintaining a comprehensive analysis of the legal and regulatory requirements for risk and going concern disclosures.

37. The Appendix to the Turnbull Guidance provides questions which the board may wish to consider in assessing the effectiveness of the company's risk and control process. Appendix D to the draft revised guidance is clearly derived from the Turnbull Appendix and provides 'questions for the board to consider and discuss with management'. However, a specific reference to the assessment of effectiveness is missing from Appendix D and is now found in Appendix E. Additionally, the sub-headings from the Appendix to the Turnbull Guidance align closely with the five components of internal control from 'Internal Control – Integrated Framework' issued by the Committee of Sponsoring Organizations of the Treadway Commission (commonly known as 'COSO'). This has helped boards demonstrate that their risk management and internal control process is effective by reference to both the Turnbull Guidance and COSO and was important in establishing that the US Securities and Exchange Commission (SEC) would accept Turnbull as an appropriate framework for complying with provisions of the Sarbanes-Oxley Act related to internal control over financial reporting. The change in emphasis of Appendix D and of its sub-headings means that it may prove difficult in future for boards to adopt a single process to satisfy UK and SEC requirements, and this will have cost implications. We suggest that the purpose of Appendix D be restated to align with the Appendix to the Turnbull Guidance and that the questions be refocused in line with the components of internal control from COSO.
38. The warning signs in Appendix E provide helpful indicators, although it is not clear to us how Appendix E is intended to complement Appendix D. Appendix E states that it is intended to be used in assessing whether the risk management and internal control system is operating effectively. However, it adopts a different approach to the Appendix to the Turnbull Guidance. We suggest that Appendices D and E are revisited to demonstrate more clearly how boards are expected to use them to assess the effectiveness of the company's risk management and internal control processes, and that boards are given a clear explanation of what the FRC is expecting boards to do differently as a result of the changes it is proposing.

Q5 – page 6: Do you believe that the approach taken in Appendix B of the draft revised guidance [which sets out how boards should assess solvency and liquidity risks] is appropriate? If not, how should it be amended and why?

39. We understand Appendix B as requiring boards to attempt to capture the principal solvency and liquidity risks before evaluating the company's going concern status. We are not convinced that this approach is one that boards will adopt other than as a theoretical compliance activity to satisfy the guidance. We do not think that an assessment of solvency, liquidity or going concern should always begin with an attempt to capture all the risks that might give rise to severe distress before proceeding to consideration of what information is available about the future. Instead, the assessment can begin with forecasts and budgets that are based on an understanding of the business and its plans that are then tested for their robustness to downside risks drawing on risk analysis that results from the company's risk management and internal control process. If the FRC's intention in Appendix B is to allow boards to test the company's forecasts and budgets against known risks and controls, then we believe this should be made clear. If not, we suggest that the FRC demonstrate that the material in Appendix B and its sequencing have been road tested and compared to what businesses actually do in practice before it issues final guidance.
40. Even if the assessment were to begin with an identification of the 'principal solvency and liquidity risks', we question whether it is practical to define them as 'those risks or combinations

of risks that... could so seriously damage the company's cash flows, performance or future prospects that they would give rise to serious distress if they materialised'. This definition does not consider the likelihood of those risks materialising. This means that 'principal solvency and liquidity risks' include a potentially limitless series of extremely damaging but highly unlikely events. While this might help the board capture black swan risks, it also requires the board to include as 'principal solvency and liquidity risks' other risks that could not reasonably be expected to form part of the board's assessment of the company's risk management and internal control process. This is potentially problematic, as Section 7 of the draft revised guidance requires principal risks and uncertainties to be described in the Strategic Report. A Strategic Report that included numerous high impact, very low probability risks would be unlikely to pass the 'fair, balanced and understandable' test.

41. For reasons set out in the preceding paragraph, we suggest that the draft revised guidance make it clear that the FRC intends 'principal solvency and liquidity risks' to be a subset of 'principal risks' (from Section 4) as defined in a way that makes it clear that high impact, very low probability risks are not considered 'principal risks'.
42. While we support the broad approach of the Sharman Panel's report, we have doubts about whether a focus on solvency is meaningful for many businesses outside the financial services sector. Companies can have net liabilities because financial reporting standards do not permit recognition of certain assets of the business. Standards can also require recognition of liabilities which do not require cash settlement. Many boards will find it difficult to understand the guidance unless such points are acknowledged.
43. As we commented in our response to the FRC's 2013 consultation on implementing Sharman, we believe more care is needed to ensure that the definition of solvency in the draft revised guidance does not conflict with existing insolvency law under the Insolvency Act.
44. We find it unfortunate that most of the FRC's thinking on assessing solvency and liquidity risks is included only in an appendix and that the guidance in Appendix B refers in its opening sentence to a further appendix, Appendix C. If the approach to assessing solvency and liquidity risks is to be retained, the key principles at least should be moved into the main body of the guidance.

Q6 – page 7: Do you agree with the guidance in Appendix C of the draft revised guidance [which sets out how boards should determine whether the going concern basis of accounting is appropriate and how they should report on it]? If not, how should it be amended and why?

45. Whether there are material uncertainties over the adoption of the going concern basis of accounting is an issue within IAS 1. The IASB has been considering whether to provide more guidance over how to determine whether there are such material uncertainties. We do not think it appropriate for the FRC to provide its own interpretation of IFRS. Furthermore, we are unclear how any such interpretation of IFRS would be enforced.
46. The draft revised guidance says that 'users may reasonably expect that matters disclosed as material uncertainties in the financial statements would have been discussed in the Strategic Report in earlier annual reports... unless they could not reasonably have been identified... at that earlier time.' We believe that this statement should be deleted because it gives incentives to directors to clutter the Strategic Report with defensive boilerplate disclosures.
47. It increases complexity and cost for business to introduce terms such as 'severe distress' and 'normal course of business' in FRC guidance for directors unless the FRC is clear about what these terms mean. The examples of what is within or outside the normal course of business are not particularly useful, as they describe extreme scenarios. Some examples which are more difficult to determine would be helpful, as the distinction is important for understanding Appendix C. For example, in the financial crisis, some businesses found themselves in financial difficulty when their loan funding was not renewed because their bank itself was in

financial trouble. It would seem harsh for any actions taken as a result to be considered outside the normal course of business but we would welcome clarification. Other examples to be addressed might include businesses which cancel planned capital expenditure, suspend dividend payments or defer creditor payments.

48. We also note that the concept of 'normal course of business' is a long-established one in legal contracts and is frequently the subject of disputes. We suggest that this makes it unsuitable for Appendix C to introduce it as a term to be used in interpreting IFRS.
49. To ensure that the second paragraph of the Appendix can be applied consistently by directors, we think that the concept of 'high level of confidence' should be deleted or subject to further guidance. It appears contradictory to state that there is a 'very high hurdle' to be cleared before there is a *departure* from the going concern basis, but to suggest that the board needs to have a 'high level of confidence' that realistic alternatives to liquidation or cessation will be effective before it can apply the going concern basis. It further confuses the picture to state that even where there is a 'high level of confidence' there may still be 'material uncertainties', given that Appendix B states the board will need to have a high level of confidence 'or else it is likely to have a going concern material uncertainty to disclose.'
50. We do not think it appropriate that material on determining and reporting on the going concern basis should only be included in an appendix. If the approach is to be retained, the key principles at least should be moved into the main body of the guidance.

Q7 – page 7: Do you agree with the revised guidance [in the Supplement for Banks]? If not, what needs to be amended and why?

51. The issue of going concern is a complex one in relation to financial services institutions. We note that for banks, the provision of an 'emphasis of matter' paragraph on going concern is 'not generally an option'. Indeed, the paragraph itself would tend to be seen by regulators as 'sufficient evidence to conclude that the institution no longer meets the requirements for authorisation under the FSMA'. Therefore, we broadly agree with the revised guidance, recognising that there is an unavoidable tension between transparent public reporting on concerns over bank liquidity and the ability of the prudential regulator to maintain public confidence in the banking system.
52. However, going concern is not the only area where reporting transparency potentially clashes with prudential regulation, and the FRC should work closely with the Prudential Regulation Authority and other regulators to ensure that the public interest is served. Particular areas of focus would include, but not be limited to, the legal requirements for directors to prepare a Strategic Report that is fair, balanced and understandable and financial accounts that give a true and fair view. Resolving these conflicts is difficult, and the FRC's role as arbiter of financial reporting, corporate governance and audit means it is uniquely placed to resolve them in the UK, taking into account the international context of UK capital markets.
53. While banks are arguably a special case, we observe that specific guidance for banks may prompt calls for guidance and exemptions for other industries too.

Q8 – page 7: Do you agree with the draft revised auditing standards? If not, what should be changed and why?

54. We agree that the marked-up changes to the draft revised auditing standards follow logically from the proposed changes to the UK Corporate Governance Code. However, we are not convinced that the explanatory material in paragraph 17-3 of ISA (UK and Ireland) 570 provides sufficient explanation of the circumstances in which auditors would decide that they had 'anything material to add' as opposed to including an emphasis of matter paragraph or qualifying their audit report. In addition, in respect of the other comments we make in this letter where we envisage implementation difficulties for directors, there will be corresponding difficulties for auditors where they have related responsibilities.

Q9 – page 10: The proposed revisions to Sections C.1 and C.2 of the Code are set out in full on [pages 11 and 12 of the Consultation Paper]. The FRC would welcome views on whether the additions are required and, if so, on the detailed wording; and on whether the existing Provision C.1.3 (on the going concern statement) should be removed.

- 55.** The consultation paper proposes four main changes to the Code which we deal with in the paragraphs that follow:
- referring to ‘principal’ rather than ‘significant’ risks in main principle C.2;
 - removing code provision C.1.3 that requires a statement on going concern;
 - introducing new code provision C.2.1; and
 - revising existing code provision C.2.1 as new code provision C.2.2.
- 56.** The consultation paper proposes updating the Code to refer to principal risks rather than significant risks although we note that the guidance still refers to significant risks in paragraph 28, paragraph 46 and Appendix D. While the change aligns the language in the Code with that in the Strategic Report, it would be helpful for directors if the draft revised guidance could make it clear whether the FRC intends there to be a difference in meaning or whether the terms are intended to be equivalent. People would generally understand ‘significant’ to be an absolute term with the consequence that riskier businesses would generally have a greater number of significant risks, whereas ‘principal’ is a relative term with the consequence that all businesses would have a similar number of principal risks. Based on this interpretation, the change from significant to principal risks is unfortunate. However, the various explanations of the term principal risk in the guidance seem to favour an absolute rather than a relative interpretation. We welcome this and think that the guidance should be explicit that principal risks have to be significant in themselves and not merely the most important risks relative to the total population of risks facing a company. In our response to Q2 we make other suggestions for improving the discussion of principal risks in the guidance.
- 57.** We do not support the removal of code provision C.1.3. The financial crisis revealed that there was confusion over the Code requirement to state that ‘the business is a going concern’. However, withdrawing the statement altogether risks perpetuating misunderstandings about going concern and sending a counterintuitive headline message that a lesson from the financial crisis is that there should be reduced expectations of boards in relation to going concern. We see value in providing an explanation in the front half of the annual report of the basis of accounting used. Therefore we suggest that C.1.3 be reworded to require a statement that ‘the business has adopted the going concern basis of accounting based on reasonable assumptions’. Furthermore, the removal of C.1.3, which explicitly stated that the going concern assessment was to be undertaken twice a year, has led some people to conclude that the going concern assessment would be annual and others to conclude that it would be continuous. If the FRC decides to remove code provision C.1.3 this matter should be clarified.
- 58.** We support new code provision C.2.1, which calls for ‘a robust assessment of the principal risks facing the company, including those that would threaten its solvency or liquidity’, on the basis that it is a substantive change arising from the financial crisis and Sharman. However, we suggest that it is shortened to remove redundant material. The end of the second sentence, ‘[the directors should] explain how the principal risks are being managed or mitigated’ restates the existing legal requirement within Section 414C of the Companies Act 2006 (implemented by SI 2013 No. 1970). There is no advantage in restating an existing Companies Act requirement in a code provision which applies on a comply or explain basis.
- 59.** Similarly, the third sentence of new code provision C.2.1, ‘[The directors] should indicate which, if any, [of the principal risks] are material uncertainties in relation to the company’s ability to adopt the going concern basis of accounting’, restates the existing requirement in paragraph 25 of IAS 1 which states: ‘When management is aware, in making its assessment, of material uncertainties related to events or conditions that may cast significant doubt upon the entity’s ability to continue as a going concern, the entity shall disclose those uncertainties’.

We see little point in restating in a comply or explain provision of the Code an existing requirement of IFRS, compliance with which is necessary for financial statements to give a true and fair view.

- 60.** We support the idea that boards should monitor risk management and internal control on an ongoing basis as well as performing an annual review. Therefore we agree with the proposed changes to existing code provision C.2.1 in new code provision C.2.2.

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