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Dear Ms Woods

**Risk Management, Internal Control and the Going Concern Basis of Accounting – Consultation on Draft Guidance to the Directors of Companies applying the UK Corporate Governance Code**

We appreciate the opportunity to respond to this important consultation by the Financial Reporting Council (FRC) on Risk, Internal Control and Going Concern. We welcomed the original initiative of the FRC to set up the Sharman Panel to identify, in the light of the financial crisis, lessons for companies and auditors addressing going concern and liquidity risks. We have also consistently supported initiatives of the FRC, for example 'Effective Company Stewardship', to reinforce the responsibilities of directors and to enhance the narrative reporting of risk information for shareholders. We are ready to contribute further views and insights on these topics to assist the FRC.

Our specific responses to each of the questions in the consultation paper are set out in the accompanying Annex. In this letter we highlight our views on what we consider to be the more important issues raised in the document.

**A significant advance on the January 2013 proposals**

We welcome the integration of the Sharman going concern principles into the guidance for directors on risk management and internal control, and the emphasis on risk management being embedded at the heart of corporate governance activities.

The enhanced narrative risk reporting, including the reporting of risks to solvency and liquidity, should enable users to better understand the risks in the context of companies' business models and help link the front and back halves of the annual report. We also support the focus on risk appetite and on culture and behaviour as part of a company's risk management framework.

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We appreciate that the FRC has responded to stakeholder comment on its previous proposals by refining its approach and that, compared to the originally envisaged timeframe, there will be a longer period for companies to reflect on and implement any changes before the revised Code and guidance become effective. We consider this appropriate, given the greater scale and scope of these changes.

### **Communicating the intended impact of the increased focus on risk**

We believe the increased focus on risk in these proposals is necessary and timely. While significant areas of the ‘integrated’ guidance are not new, we consider the increased attention that boards should now pay to aspects such as risk appetite and how they manage risk does represent an important change of emphasis. Events of recent years have demonstrated the importance of the board – in practice – having a proper understanding of risk appetite and a clear line of sight into how it manages and mitigates the risks it takes on. These issues have had a particularly high profile in the financial services sector, but we believe there are also wider lessons to learn from the crisis for all companies.

Hence we believe it is of vital importance that the FRC does more to communicate the scale of this intended change in emphasis. Without this, there is a risk that companies, particularly those not in the financial services sector, will under-estimate the impact of the new guidance. The current presentation and structure of the document, as we note further in our detailed response below, do not help in this regard. The proposals would be easier to assimilate and the changes more readily understood if the structure of the sections is streamlined and the document written in a simpler style. An introductory or executive summary section that clearly indicates the FRC’s views on the “depth” of the change and highlights what is new would be helpful. Such a summary will mean companies do not expend effort in attempting to decipher and interpret the guidance and can instead move on to implementing and deriving the benefit from it.

### **Clarifying the purpose of the new Code provisions and what boards need to do**

It is crucial for the success of the guidance that directors understand the scope of what they are being asked to do. A significant change over current practice is the proposed ‘robust assessment’ by the directors of the principal risks facing the company, including those that would threaten its solvency and liquidity. This new provision is in addition to the existing one relating to the ongoing system of risk management and internal control and the at least annual review of the effectiveness of that system by the board, but the new provision also requires an explanation of how the principal risks have been managed and mitigated. There is room for uncertainty about how the two provisions relate which could lead to disclosures that lack the desired insight.

The risks to be addressed in the board’s ‘robust assessment’ of the principal risks facing the company, and the scope of the board’s monitoring and review of the company’s risk management and internal control, both extend wider than those financial risks that impact the financial statements. Consistent with our views above, we believe it is important that

directors are given clarity regarding the recommended disclosures and the changes in behaviour that are expected to be brought about through the assessment and related reporting.

The FRC has not provided any illustrative examples of potential processes or the proposed directors' statements that would arise from them and, while we understand the desire to avoid such examples becoming 'boilerplate', we believe more help will be needed in order for the proposals to have the intended impact. In particular, we believe the FRC should provide a definition of the term "significant failing" in relation to internal control. Furthermore, providing appropriate illustrations might also help the FRC to communicate that this is intended to be a change in how companies think about and report on risks. We would be willing to work with the FRC to help develop illustrative materials in terms of both appropriate processes to address particular situations and how to disclose them.

With reference specifically to liquidity and solvency risks and the assessment of going concern, we believe the directors would need to explain the need for and sources of funding for the company, the risk factors attached to those funding sources and to the sustainability of the business model, and the key related assumptions that they have made in assessing going concern in preparing the financial statements.

### **Auditors' responsibilities to review and report on the directors' statement**

The scope of the auditors' reporting needs to be clear to users of the annual report and reasonable based on the scope of work undertaken for the purposes of the audit. However, the broad nature of the directors' statements on risk required by the proposed new Code provision goes beyond those matters relevant to the financial statements. We believe that the resulting mismatch between the auditors' scope of work and the directors' reporting may not be understood by readers.

The proposed form of auditor reporting – whether they have "anything material to add or draw attention to" in relation to the directors' statements – is too loose. The directors' statement and the reporting of the annual review of the risk management and internal control system are both about process and therefore the auditor reporting should focus on whether those processes have been appropriately captured in the disclosures.

In respect of liquidity and solvency risks, the auditors could confirm that the key assumptions disclosed are those that the directors considered in making their going concern assessment and that, based on their evaluation of those assumptions, the auditors have no reason to believe they are not a reasonable basis for the directors' going concern assessment.

### **Financial reporting aspects of Going Concern**

We continue to believe that the current financial reporting and auditing conventions regarding going concern are generally well understood and have worked relatively well, including through the years of the financial crisis.



We note that the FRC proposes that Code requirement C.1.3 be dropped (and that the FRC will discuss with the FCA a possible change to drop the equivalent requirement in the Listing Rules). We would have preferred to see greater elaboration in the consultation document of the arguments for and against doing so.

We believe most stakeholders associate the assertion under C.1.3 with the financial reporting assessment of going concern. While the new statements and disclosures regarding risks to be provided by the directors are valuable, we question whether they are a substitute for the going concern statement. Some stakeholders may perceive that something that is clear and that provides a link with financial reporting aspects of going concern has been deleted and 'replaced' by something that is more comprehensive but less concise and clear with specific reference to going concern. A solution might be to retain this in the Code, but make clear that this is related to the financial reporting assessment of going concern and/or by requiring that the directors' statement and accompanying explanation of assumptions be included in the accounting policies note in the financial statements. (In our audit reports for Code companies, we have expanded on the directors' statement by reporting that as part of our audit we have concluded that the directors' use of the going concern assumption is appropriate.)

As noted in our detailed responses below, we consider that the proposed Appendix C *'Determining and Reporting on the Going Concern Basis of Accounting'* retains too many concepts and terminology from the January 2013 proposals which are not currently used or well understood and which in our view will not help directors in their assessment of going concern. We do not believe it is necessary for the FRC to embellish the current accounting requirements on going concern, which are defined in international standards and which, in our view, are relatively well understood. We suggest much of Appendix C could be omitted.

### **Consistency with international developments**

Concurrent with the FRC's initiative, developments are taking place internationally in regard to going concern. The IASB has considered whether limited amendments might be made to the financial reporting requirements on going concern in IAS 1. The US FASB has also consulted recently on new going concern guidance. In relation to auditing, the IAASB's recent Exposure Draft on Audit Reporting proposed that audit reports will in all cases include a new section and statements by the auditor regarding going concern. The outcome of some of these other projects is not expected to be known until at least mid-2014, and possibly longer in some cases.

The FRC should continue to be innovative and take a lead in the international debate, while being mindful that achievement of international consistency is a key objective.

### **Proposed guidance for banks**

The revised Guidance for Directors of Banks is largely unchanged from that consulted on in January 2013, and states that liquidity support from central banks may be a normal funding source for banks and reliance on such support does not necessarily mean that a bank is not a



going concern or that material uncertainties should be disclosed or that an emphasis of matter paragraph should be included in the auditor's report.

We continue to believe that greater consideration should be given to the context of the overall corporate reporting and disclosure regime. As we explain further in the attached Annex (and as noted in our April 2013 response to the previous consultation), non-disclosure of substantial support from Bank of England facilities should be considered also in relation to other disclosures required by accounting standards in order to give a true and fair view and to other disclosure obligations of directors. Without full consideration of the broader disclosure regime, it seems unreasonable to expect the directors or the auditors to conclude as a generality that such support will always be regarded as being in the normal course of business and hence not disclosable. The consequences of non-disclosure need to be viewed in the broader context and not simply in relation to the assessment and disclosure of going concern and it would be helpful if the FRC addressed these broader aspects in the proposed Guidance for Directors of Banks as well.

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We would be delighted to discuss our views further with you. If you have any questions in the meantime regarding this letter, please contact Gillian Lord (0207 804 8123), Graham Gilmour (0207 804 2297) or John Patterson (01223 552413).

Yours sincerely

PricewaterhouseCoopers LLP

## **Responses to specific questions in the consultation paper**

**The FRC would welcome views on whether the draft revised guidance achieves these objectives [greater focus on risk] and on the structure of, and level of detail in, the draft revised guidance.**

- We consider that the principle of merging in a single set of guidance the internal control, risk management and going concern aspects is a good one, providing a single source of reference material for companies.
- The document is however relatively unwieldy in structure – with too many different sections and appendices – and hence not very easy to read. It would be preferable if the structure was rationalised and the guidance written more in the ‘plain English’ principle-based style of the 2005 Turnbull guidance.
- As noted in our covering letter, we believe the final version of the guidance should include an executive summary section that indicates the FRC’s views on the scale of change intended and that highlights for company directors and other users those aspects of the guidance that are new and which may require companies to do things differently.
- We also believe that the communications around the final version of the guidance could usefully explain how it is positioned in the context of other recent initiatives by the FRC, such as the Strategic Report and the new disclosures around assessed risks in auditors’ reports on Code companies, particularly where there are areas of overlap.
- The FRC’s 2008-09 Guidance for Directors on Going Concern was well received by stakeholders and proved useful during the financial crisis. We suggest the FRC review this guidance and consider incorporating those aspects that remain helpful in the proposed merged guidance.

**Do you agree that Sections 5 and 6 of the revised guidance on internal control remain fit for purpose and largely unchanged from 2005 guidance, or are more substantive changes to these sections required?**

- The 2005 Turnbull guidance has generally been accepted and understood by the market, so the principle of retaining much of this in relatively unchanged form seems an appropriate one. Since a number of years have passed since the original guidance was published, and since the principles were perhaps not in all cases fully observed and/or reported on effectively, it does seem opportune to remind companies of its importance and of the main provisions.
- It is proposed that the Code be amended (new C.2.2) to amplify the fact that the board should *monitor* the company’s risk management and internal control, as well as conducting an annual review of effectiveness. We agree that it is important to reinforce the fact that this is not a ‘one-off’ annual review exercise. We believe the guidance should further emphasise that is not simply a case of management reporting upwards to the board so that they can discharge their monitoring responsibility –

there should be a two-way dialogue such that the board challenges and probes management's operational processes and the reporting of findings.

- There are a number of references in the guidance to "risk culture" (for example in Section 2). We suggest the use of this term is reviewed and clarified – in our view the culture of the organisation is a single concept, and drives an organisation's attitude to risk. We do not believe that the concept of "risk culture" should (or can be) separately defined.
- Section 3 on exercising responsibilities notes, in relation to the use made of board committees, that the board should determine the extent to which it wishes to obtain advice from or delegate responsibilities to, the risk committee or audit committee. We believe a central message of the guidance is that risk management is an important responsibility of the board and the FRC should consider whether the words "or delegate responsibilities to" could be perceived as undermining this.
- Section 6 on reviewing the risk management and internal control system does not discuss design and operating effectiveness of controls. As the Code now makes it clear that both the ongoing monitoring and the annual review should examine all material controls (including financial, operational and compliance controls), the guidance could usefully draw out that companies may now need to review the design and operating effectiveness of these controls.

**The FRC proposes to amend 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" of the internal control system. The FRC would welcome views on this proposed change to the guidance.**

- While appreciating the rationale for this change, we consider that directors will seek clarity as to what type of matters the FRC may have had in mind to be reported and what the disclosure might look like. The FRC should define what is meant by 'significant failing' and clarify the benchmark for disclosure of such a failing and for the related remedial actions. While we understand the reluctance to provide illustrative examples, lest these be used or copied unthinkingly, we consider it would be helpful for the FRC to give greater guidance as to the type of matters that would be suitable for explanation.
- There should also be greater thought given to whether this will result in companies (or auditors) being required to report new information to the market, for example on risk management weaknesses or breakdowns in control. To the extent such weaknesses are already communicated to the market under existing reporting conventions and hence in the public domain, this should not be problematic. But for disclosures that are 'new', how will investors and the market respond? Could this lead to unintended consequences? While more disclosure than currently exists may be appropriate and desirable, we presume it is not the FRC's aim to have disclosure of many smaller items that may be considered 'failings', and that the focus is more on greater explanation of actions taken on the type of items that might already be disclosed. We believe the FRC should help companies by being clearer about what 'good' disclosure means in this area.



**The FRC would welcome views on whether Appendices D and E are of use to directors and, if so, how they might be improved.**

- We consider the content of these appendices to be appropriate and helpful, and suggest that the aspects around culture and behaviour could be given greater prominence.

**Do you believe that the approach taken in Appendix B of the draft revised guidance is appropriate? If not, how should it be amended and why?**

- We support the focus on both liquidity and solvency, while recognising that the majority of businesses that fail do so because they run out of cash, rather than that they run out of capital, and hence for many companies liquidity may be the more important aspect.
- In general, we concur with the FRC's avoidance of a prescriptive approach to the level of attention paid to each aspect and to liquidity and solvency stress testing. It is important that companies have the flexibility to design tests appropriate to their circumstances. This is an area where it may be helpful to consider benchmark practices in different business sectors and, potentially, additional guidance.
- On a point of detail, we recommend that the wording of the opening paragraph of Appendix B is changed to avoid the risk that companies interpret this as meaning that they should not provide commentary on liquidity or solvency risks if they are not currently likely to lead to 'severe distress'.
- In relation to banks, we note that the Bank of England and PRA have recently consulted on stress testing of banks (*A framework for stress testing the UK banking system – A Discussion Paper*, October 2013). The Bank's paper does not provide precise tests that banks should apply, but does set out the objectives of stress testing and proposed principles for frequency and timing of tests and scenario design. It also discusses the benefits and costs of disclosure of the outcome of tests. We believe benchmarks for stress testing will become more specific as work in this area evolves, and that it would be helpful for the FRC to consider aligning its efforts and expectations with the Bank and the PRA.

**Do you agree with the guidance in Appendix C of the draft revised guidance? If not, how should it be amended and why?**

- There is a risk that the FRC may be perceived to be "setting GAAP" by providing guidance that embellishes the current accounting requirements for going concern, which are defined in international standards.
- We consider that Appendix C retains too many concepts and terminology from the January 2013 proposals which are not currently used or well understood and which in our view will not help directors in their assessment of going concern or auditors in their review of the directors' assessment. (For example, the distinction between actions "inside/outside the ordinary course of business" is somewhat academic, and does not affect the ultimate responsibility to determine whether the company is or is



not a going concern, or if there is a material uncertainty). We suggest much of Appendix C could be omitted.

- It is important that, to the maximum extent possible, there is common understanding internationally of the concepts around going concern. As noted in our covering letter, there are a number of initiatives taking place internationally in regard to going concern. The FRC should continue to take a lead in these debates, while being mindful that international consistency is a key objective.
- We are concerned by the implications of the penultimate paragraph in Appendix C. Inevitably, reviews of company reports will be undertaken with the benefit of hindsight, however, at the same time, a reasonable approach should be taken by those conducting regulatory reviews that the focus is on whether the directors' considerations and disclosures were reasonable on the basis of available information at the time.
- Above all, it will be important that the final guidance explains how the risk disclosures in the 'front half' of annual reports link to any disclosure of material uncertainties in the financial statements in the 'back half' so that all parties are clear at what point a narrative risk generates an emphasis of matter.

**Do you agree with the revised guidance to directors of banks? If not, what needs to be amended and why?**

- The revised guidance for banks is largely unchanged from that consulted on in January 2013, and we reiterate below many of our comments from our previous response letter of April 2013.
- The Sharman Panel of Inquiry was established largely in response to the severe financial distress situations experienced by banks at the height of the financial crisis in 2007-08. Enhanced narrative disclosure of a bank's business model and analysis of where its funding is coming from will help (as will adoption by UK banks of the recommendations in the November 2012 report of the Enhanced Disclosure Task Force sponsored by the Financial Stability Board). The enhanced analysis and disclosure of risks, including solvency and liquidity risks, recommended by the FRC for all Code companies, will also be beneficial in the case of banks. Cases of distress may be less likely to occur if assessments of solvency and liquidity are performed on a regular basis and built into the bank's normal control processes together with enhanced internal reporting routines.
- The Sharman report did illustrate that there is a valid debate to be had about the extent of going concern disclosure that is appropriate for banks and helpfully set out the legitimate twin public interest objectives of transparency for investors and financial stability.
- The proposed guidance confirms that liquidity support from central banks (where there is a high level of confidence that those facilities will be accessible by the bank to a sufficient extent and over a sufficient time period) may be a normal funding source for banks and reliance on such support does not necessarily mean that the bank is not a going concern or that material uncertainties should be publicly disclosed or an emphasis of matter paragraph included in the auditor's report. Hence, under the guidance, the use of Bank of England facilities such as the Discount Window Facility

(DWF) is not disclosable as a material uncertainty if the Bank has concluded the institution is solvent and it can repay what it borrows.

- However we consider that more thought should be given to the disclosures required more widely in corporate reports and the linkages between them, and not simply the going concern disclosures in isolation. For example, even if the Bank of England and an institution using the DWF are not related parties (which would if applicable likely trigger disclosures of material related party transactions), disclosure of substantial material borrowings from the Bank (which could run to £billions at off-market rates) would potentially need to be disclosed in order to comply with requirements in international accounting standards (for example IFRS 7 for liquidity disclosures) in order to give a true and fair view.
- We also observe that for banks, unlike other types of company, there seems to be no limit on what might be considered to be a “normal” funding source – these includes sources of finance that are not available to any other type of entity on equivalent terms.
- While the legitimate intention of the FRC and the UK regulatory authorities is, through this guidance, to preserve financial stability, we believe that non-disclosure of substantial support from Bank of England facilities needs to be considered also in relation to the broader context of other disclosures required by accounting standards in order to give a true and fair view and to other disclosure obligations of directors. Without full consideration of the broader disclosure regime, it seems unreasonable to expect the directors or the auditors to conclude as a generality that such support will always be regarded as being in the normal course of business and hence not disclosable.
- The proposed Guidance does not remove the difficult judgments that must be made where a bank is subject to uncertainties that raise concern but where these are not yet at a level where the bank has entered discussions with the authorities about obtaining support. Disclosure of uncertainties in those circumstances may still result in a loss of market confidence in the bank, with the attendant consequences.

**Do you agree with the draft revised auditing standards? If not, what should be changed and why?**

- As noted in our covering letter, the broad nature of the directors’ statements on risk required by the proposed new Code provision goes beyond those matters relevant to the financial statements. We believe that the resulting mismatch between the auditors’ scope of work and the directors’ reporting may not be understood by readers.
- We consider the proposed form of auditor reporting – whether they have “anything material to add or draw attention to” in relation to the directors’ statements – is too loose. The directors’ statement and the reporting of the annual review of the risk management and internal control system are primarily about process and therefore it would be preferable if the auditor reporting focused on whether those processes have been appropriately captured in the disclosures. In respect of liquidity and solvency risks, the auditors could confirm that the key assumptions disclosed are those that the directors considered in making their going concern assessment and that, based on



their evaluation of those assumptions, the auditors have no reason to believe they are not a reasonable basis for the directors' going concern assessment.

- We note that the wording proposed in a few places, such as ISA 260.A20-6, is derived from the proposed new Code provision C2.1. This refers to indicating "...material uncertainties in relation to the company's ability to continue to adopt the going concern basis of accounting." Auditors (and users of financial statements) have become familiar with the wording in ISA 570 regarding "material uncertainties that may cast significant doubt about the company's ability to continue...", and we suggest the FRC consider whether "significant doubt" should be included in the new Code provision C2.1.