Deloitte.

November 2013

Governance *in brief*
FRC consults on new, integrated guidance on risk management, internal control and going concern

Headlines

Going concern

- Proposed replacement of the front half statement that the business is a going concern with a requirement that the board performs a robust assessment of the principal solvency and liquidity risks facing the company. This assessment should form part of the broader risk management assessment, identifying which (if any) of those risks represents a material uncertainty in relation to the company's ability to continue to adopt the going concern basis of accounting.
- Existing financial reporting requirements in respect of the going concern basis of accounting remain – the directors must determine whether it is appropriate to adopt the going concern basis and to disclose this together with any material uncertainties in the financial statements.

Risk management and internal control

- UK Corporate Governance Code will require board to monitor risk management and internal control on an on-going basis, replacing existing duty to review "at least annually".
- Revised duty supported by much greater guidance for boards on risk management processes.
- Encourages more comprehensive disclosure of principal risks, risk management and internal control.
- Introduces a new disclosure requirement to explain actions taken by the board to remedy any significant failings or weaknesses identified.
- Proposes new reporting requirements for auditors on risk management and internal control.
- Supplemental guidance proposed for directors of banks on solvency and liquidity.

Introduction

The FRC is proposing to replace their existing 'Internal Control: Guidance for Directors' (2005) and 'Going Concern and Liquidity Risk: Guidance for Directors' (2009) with one set of integrated guidance which will also reflect their 2012 'Boards and Risk' paper. This will implement the Sharman principles on going concern, taking on board feedback from their January 2013 consultation. Boards will have one broad on-going process to consider risk identification and management, including the assessment of solvency and liquidity risks, and to determine whether the company is able to adopt the going concern basis of accounting and enhance reporting on internal control.

Going concern

Under these proposals the requirement for a separate positive statement by the board that the business is a going concern is to be removed from the Code. If, as a result of this consultation, the FRC proposes to amend the Code, it will discuss with the FCA a possible change to the Listing Rules. Disclosures about material uncertainties identified by the board in relation to going concern should be linked to reporting on principal risks and uncertainties in the Strategic Report.

In the financial statements, three reporting scenarios follow from the board's determination whether to adopt the going concern basis of accounting and whether there are material uncertainties:

a) **"the going concern basis of accounting is appropriate and there are no material uncertainties**. The board should confirm it has adopted the going concern basis of accounting as part of its financial statements and make the disclosures, including those about solvency and liquidity risks, necessary to give a true and fair view; or

b) **the going concern basis of accounting is appropriate but there are material uncertainties**. The board should confirm it has adopted the going concern basis of accounting in preparing the financial statements, disclose the material uncertainties and make the other disclosures, including those about solvency and liquidity risks, necessary to give a true and fair view; or

c) **the going concern basis of accounting is not appropriate.** Such a conclusion will be very rare. The board should: disclose its conclusion; if appropriate, adopt a liquidation basis of accounting and disclose the basis of accounting adopted; and make the other disclosures, including those about solvency and liquidity risks, necessary to give a true and fair view."

'High level of confidence'

One of the most controversial aspects of the FRC consultation earlier this year was the phrase "high level of confidence in association with going concern through the business cycle". The FRC had suggested that a company should be "judged to be a going concern if, for the foreseeable future, there is a high level of confidence that it will have the necessary liquid resources to meet its liabilities as they fall due….".

The draft guidance narrows the use of the 'high level of confidence' threshold to the board's consideration that solvency and liquidity risks can be managed effectively during a period of at least the twelve months from the date of approval of the financial statements. If not, it is likely that they will need to disclose a material uncertainty relating to the ability of the entity to continue using the going concern basis of accounting.

Approach taken in the draft guidance in relation to risk and internal control

Sections 2 to 4 of the draft revised guidance provide more extensive guidance on 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.

Sections 5 and 6 of the draft revised guidance address the design and process for reviewing the risk management and internal control system. They are largely unchanged from sections 2 and 3 of the current internal control guidance. Section 7 covers communication of risk management, internal control and going concern and is written to be consistent with the FRC's draft guidance on the Strategic Report.

Appendices to the draft guidance include questions which boards may wish to consider in applying the guidance and indicators that may assist them in assessing how they are carrying out their responsibilities, the culture of the company, and the effectiveness of the risk management and internal control system. These suggestions are quite extensive and, as with many such suggestions, they will likely become additional standard procedures at board level, some of which are now delegated to management.

Identifying and assessing principal risks

The draft guidance states that 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;

- assess the availability and likely effectiveness of actions that they would consider undertaking, either in advance or when a trigger event occurs, to avoid or reduce the impact of the underlying risks; and

- be aware of those risks (or combination of risks) that could seriously affect the future performance, solvency or liquidity of the company.

The guidance makes it clear that the design of the assessment process should be appropriate to the complexity, size and circumstances of the company and is a matter of judgement for the board, with the support of management. In determining the impact of a risk materialising, the board must be clear about the extent to which there are residual risks even where risk management processes, internal controls and contingency plans are operating effectively. The guidance suggests that the board should consider undertaking stress tests and reverse stress tests to review different scenarios.

Assessing solvency and liquidity risks

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.

The draft guidance does not define "severe distress" precisely and makes it clear that it is a "matter of judgement", but as an indication the guidance suggests that a symptom of severe distress would be where the company has no realistic alternative but to take significant actions outside the normal course of business to address the distress. Examples of such actions are given:

- discontinuing or materially curtailing the company's operations; or
- raising finance (or making changes to existing finance) outside the normal course of business or on other than normal terms or doing so from other than normal sources.

Appendix C of the draft guidance sets out some examples to help differentiate between taking actions within or outside the normal course of business.

Reporting on risk

The draft guidance intends that the board's risk review process informs three distinct but related disclosures in the annual report relating to risk:

- the principal risks and uncertainties set out in the strategic report;
- the preparation of the financial statements on the going concern basis of accounting and any related disclosure of material uncertainties; and
- reporting on the review of the risk management and internal control system.

Boards should provide succinct, meaningful information that is tailored to the specific circumstances of the company, avoiding boilerplate that is "long on detail but short on insight".

Principal risks and uncertainties

The guidance seeks to extend current practice by indicating that to be effective risk descriptions should include:

- sufficient specific detail that a shareholder can understand why they are important to the company;
- a description of the likelihood of the risk;
- an indication of when the risk might be most relevant to the entity and its possible effect;
- details of any significant changes in principal risks, such as a change in the likelihood or possible effect, or the inclusion of new risks;
- a high-level explanation of how the principal risks and uncertainties are being managed or mitigated; and
- a description of how more generic risks or uncertainties might affect the entity specifically.

There should be an explicit indication of which, if any, of the principal risks and uncertainties are also material uncertainties for the purposes of reporting in the financial statements on the company's ability to continue to adopt the going concern basis of accounting.

Statement on risk management and internal control

The board's statement on its review of the effectiveness of the company's risk management and internal control systems is unchanged but the draft guidance does make it clear that there should be good linkage between the disclosures on the review of the risk management and internal control systems to the information on principal risks and uncertainties in the Strategic Report and the material uncertainties, if any are disclosed, relating to the going concern basis of accounting in the financial statements.

Significant failings or weaknesses identified

There is a significant change proposed to the disclosures around any significant failings or weaknesses identified from the board review. In the past the board was required to "confirm" that action had been taken to address or deal with any significant failing or weakness identified but the FRC has noted that most companies simply cut and paste this statement into their annual report without any further detail. The proposal is that the board now has to "**explain** what actions have been or are being taken to remedy any significant failings or weaknesses identified" from the board's review, including "the process it has applied to deal with material risk management or internal control aspects of any significant problems disclosed in the annual report and accounts".

Changes proposed to the UK Corporate Governance Code

At present the 2012 edition of the UK Corporate Governance Code includes the following provision within the 'Financial and Business Reporting' section in relation to going concern:

C.1.3 The directors should report in the annual and half yearly financial statements that the business is a going concern, with supporting assumptions or qualifications as necessary.

The FRC is proposing to replace this provision with an amended C.2.1 as follows:

NEW C.2.1 The board should carry out a robust assessment of the principal risks facing the company, including those that would threaten its solvency and liquidity. In the annual report the directors should confirm that they have carried out such an assessment and explain how the principal risks are being managed or mitigated. They should indicate which, if any, are material uncertainties in relation to the company's ability to continue to adopt the going concern basis of accounting.

Code Provision C.2.2 will also be amended to require the board to maintain continuous oversight of the risk management and internal control systems, rather than just suggesting the need for an annual exercise:

C.2.2 The board should monitor the company's risk management and internal control and, at least annually, carry out a review of their effectiveness, and report to shareholders that they have done so. The monitoring and review should cover all material controls, including financial, operational and compliance controls.

New responsibilities for auditors in relation to the directors' reporting of risks

The FRC proposes that the auditor's report should state whether they have anything material to add or draw attention to in relation to:

- the directors' statement that they have carried out a robust assessment of the principal risks facing the company, including those that would threaten its solvency or liquidity; and

- the disclosures in the annual report that address how those risks are being managed or mitigated and which, if any, are material uncertainties in relation to the company's ability to continue to adopt the going concern basis of accounting.

In addition, in the auditor's private report to the audit committee, auditors will be required to report their views about the robustness of the directors' assessment of the principal risks facing the company, including those that would threaten its solvency and liquidity, the outcome of that assessment and the related disclosures.

Guidance for directors of banks

The FRC has issued for consultation a supplementary document 'Guidance for the Directors of Banks: Solvency and Liquidity Risks and the Going Concern Basis of Accounting'. This proposed Guidance is relatively unchanged from that originally proposed in January 2013 and covers the more intense liquidity and solvency risks arising from the business models of most banks; their vulnerability to confidence in the sustainability of their funding models; and the need for close co-operation between banks, their prudential supervisors and their auditors.

Timetable for implementation

The FRC's proposals would apply to reporting periods beginning on or after 1 October 2014. For a company with a December year-end this would first apply for the year ending 31 December 2015.

Applicability to AIM companies and companies with a standard listing

While the FRC hopes this guidance will be useful to all organisations, it is primarily addressed to companies subject to the UK Corporate Governance Code (i.e. companies with a premium listing of equity shares in the UK). The FRC plans to issue separate guidance on going concern for other companies.

Matters you may wish to consider when preparing your response to this consultation

The FRC is asking for views on a number of matters within the consultation paper. We suggest that the following areas are also worthy of consideration:

- Should the Code's provision requiring a board statement that the business is a going concern be removed? Or is the current front half board statement useful to reinforce board responsibility and process in relation to the going concern assessment? Will the new disclosures on solvency and liquidity downside risks provide a sufficiently clear conclusion for investors in the absence of the front half confirmation of the going concern basis?

- Is there sufficient clarity around the terminology such as "principal risks", "significant failings or weaknesses" and "material controls"? For example, the guidance focuses on disclosure of principal risks, but the monitoring and review of internal controls must cover all material controls and the reporting requirements envisage reporting on weaknesses and remedies in all material controls.

- Is there benefit to disclosing weaknesses in controls and their remediation in the circumstances where no loss has occurred?

- Do the reporting changes result in an increase in board responsibility? What will be the implications for risk management and controls assurance processes at companies? Are internal audit and risk management and assurance functions adequately set up and staffed? Will this see more deployment of methodologies such as "cashflow at risk" models?

- Will there be enhanced management rigour from these proposals? Or will they be seen as a significant increased cost for UK premium listed businesses?

- How will auditors react to their proposed new reporting responsibilities? Will companies welcome the extension in scope for auditors in relation to the directors' statement on principal risks and their management?

Deloitte view

- This is a complex consultation paper with many different and significant components. Boards should take time to read it carefully – there are very important implications. Boards should also consider sending in a response from their company to the FRC.

- Although a welcome "cutting clutter" initiative, we have some reservations about dropping the requirement for boards to state in the front half that the business is a going concern, as the proposed discussions on liquidity and solvency risks on their own may lack the clarity of conclusion which the going concern board statement provided.

- Most non-executive directors view the on-going management of risk as an executive function with oversight from the board. The consultation paper emphasises the board's overall responsibility and will likely stimulate a rethink in the whole structure of risk management, risk committees and the role of the audit committee in relation to risk management.

- There are new risk reporting responsibilities for the auditor being proposed in this consultation.

Contacts – we value your feedback:

corporategovernance@deloitte.co.uk

If you find our publications useful or would like to see other topics covered please provide your feedback.

Tracy Gordon
020 7007 3812 or trgordon@deloitte.co.uk

William Touche
020 7007 3352 or wtouche@deloitte.co.uk

The Deloitte Academy

The Deloitte Academy, located on the ground floor of Deloitte's Stonecutter Court offices, has been designed for main board directors of listed companies. The Deloitte Academy provides support and guidance to boards, individual directors and company secretaries of listed companies through a programme of briefings and update sessions. Bespoke training for the whole board or individual directors is also available.

If you would like further details about the Deloitte Academy, including membership enquiries, please email enquiries@deloitteacademy.co.uk

UK Centre for Corporate Governance

For further information on corporate governance matters please click here
http://www.corpgov.deloitte.com/site/uk/

Deloitte LLP is a limited liability partnership registered in England and Wales with registered number OC303675 and its registered office at 2 New Street Square, London EC4A 3BZ, United Kingdom. Tel: +44 (0) 20 7936 3000 Fax: +44 (0) 20 7583 1198.

Designed and produced by The Creative Studio at Deloitte, London. 31341A