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

Dear Ms Woods

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

The GC100 is the association for the general counsel and company secretaries of companies in the UK's FTSE 100. There are currently over 125 members of the group, representing some 81 companies. We welcome the opportunity to respond to the consultation paper "Risk Management, Internal Control and the Going Concern Basis of Accounting" published by the Financial Reporting Council ("FRC") in November 2013. Please note, as a matter of formality, that the views expressed in this letter do not necessarily reflect those of each and every individual member of the GC100 or their employing companies.

Before responding to the specific questions raised in the consultation paper, we would like to offer some general thoughts.

1. We are pleased that the FRC has acknowledged the concerns raised by us and other respondents to the FRC's previous consultation and has set out afresh how it will implement Lord Sharman's recommendations. However, we are unclear as to the purpose of the revised guidance, in terms of the change in approach and behaviour you are attempting to stimulate from businesses and boards. The principles of risk management and the components of an effective internal control environment are well understood in most boardrooms, and the recent financial crisis has emphasised to many boards that the adoption of the going concern basis of accounting must first be justified by the company's solvency and liquidity position, stress-tested against a range of risk factors.
2. We are also concerned that while the draft revised guidance presents a very extensive list of what boards and management teams are now expected to do, there is very little explanation of how this is to be done, even at a high level. In addition, while the systematic quantification of financial risk is commonplace in financial services, it is very much harder to replicate for qualitative risks in all sectors. If you are trying to stimulate a general uplifting of the standards of risk management, then issuing guidance on how these proposed new duties can be implemented in practice, which is currently lacking in the draft revised guidance, would be beneficial.
3. While the consultation paper states (in the second bullet at the foot of page 1) that "*Risk management and internal control should be incorporated within the company's normal management and governance processes, not treated as a separate compliance exercise*", we do not believe that the draft revised guidance promotes that approach. The sheer volume of

work which the guidance would require boards to discharge does not strike us as being easily accommodated alongside the directors' existing responsibilities and obligations, nor as likely of being readily integrated into the existing processes by which the business is managed. We entirely agree that the processes of managing risk and managing the business are one and the same, but would recommend that the FRC re-approaches the question of how boards and management teams go about managing risk, given their many other obligations and duties.

4. In various places the draft revised guidance places significant executive obligations on boards which, in listed companies subject to the UK Corporate Governance Code, will be dominated by non-executive directors – examples of this occur in paragraphs 5, 20, 24, 27 and 28. We would urge the FRC to give greater thought to the roles of management and the board in this context.
5. The use of the term “principal risks” throughout the consultation paper and the draft revised guidance is confusing. This term is used in the Companies Act 2006 in relation to a reporting obligation, which most companies interpret as equivalent to the more commonly used definition of “significant” risks (indeed, the FRC has previously encouraged companies to adopt this approach). At various points in the draft revised guidance the word “principal” is used in ways which we do not think the FRC intends it to be interpreted. We would urge the FRC to use “risk”, “material risk” and “significant risk” in their accepted senses and not cloud the document by using a term which has a very particular application.
6. Issuers are required under the FCA’s Disclosure and Transparency Rules to disclose information (which could have a significant effect on the price of the company’s shares) to the market as soon as possible. Separately, the board, normally based upon representations from management following review by the audit committee, makes an annual statement in the annual report that the company is a going concern for accounting purposes and that it has assessed the effectiveness of the internal controls by reference to a fixed point in the year, reflecting the opinion of the auditors that the financial statements are true and fair at that point. The more onerous continuing obligation proposals set out in the draft guidance risk creating a tension between these two existing requirements and could lead to ‘hindsight’ arguments as to why something that happened during the year was not disclosed immediately. Given the existing requirement for companies to disclose material information to the market as soon as possible, there is a risk of an increase in the quantity (but not quality) of unnecessary disclosure announcements. We are concerned that these additional requirements will not actually improve the quality of reporting, but will create additional layers of risk compliance.
7. Following the CG100’s comments on the previous FRC consultation, we welcome the FRC’s revised approach in the draft guidance to going concern. It is our view that the term “going concern” should be limited to the statement included in financial statements and that narrative reporting on risks should not be linked to the going concern assertion.

We have offered a number of drafting suggestions, appended to this letter, in support of these general observations and the specific points made in our responses to the various questions below.

Question 1 (page 3): The FRC would welcome views on whether the draft revised guidance achieves these objectives, and on the structure of, and level of detail in, the draft revised guidance?

We support the FRC’s objective of updating the 2005 guidance, to align better with more recent versions of the Code and the 2011 guidance. However, we do not feel that, as currently drafted, the draft revised guidance fully achieves the objective. We have already highlighted that there is

excessive focus on ‘what’ is to be done, and too little guidance on ‘how’ this is best achieved; that duties which should fall on management are instead allocated to the board and that the sheer volume of what is proposed will not easily fall within existing board processes. We also found the structure of the draft revised guidance and its numerous appendices unhelpful. In summary, while we are sympathetic with and supportive of the FRC’s over-arching aims, we found the draft revised guidance less helpful than its 2005 predecessor.

Question 2 (page 3): Do you agree or are more substantive changes to these sections [5 and 6] required?

We believe that sections 5 and 6 are broadly fit for purpose, but that these would be enhanced by a requirement (in section 7) for the company to summarise the nature and extent of the material risks they are willing to accept in pursuit of the company’s strategic objectives.

Question 3 (page 4): The FRC would welcome views on this proposed change [disclosure of any failings in the internal control environment] to the guidance?

We are doubtful as to what this proposal will achieve. Members have variously voiced concerns in relation to confidentiality (particularly where situations have occurred which revealed failings in the internal control environment) and how to disclose material (but not significant) failings identified in the routine review.

For any failing, there are three possible outcomes – the failing has been corrected (in which case the disclosure is of very limited value), or it has not been corrected (perhaps because the cost/benefit balance is not to shareholders’ advantage) or it cannot be corrected. We are concerned that this new requirement could result in narrative which will of necessity need to create context to explain whatever outcome has occurred, resulting in lengthy, but largely uninformative discussion.

Question 4 (page 4): The FRC would welcome views on whether these appendices are of use to directors and, if so, how they might be improved?

Our feeling is that Appendix A serves little purpose. We comment separately on Appendix C in our response to question 6 below. Appendix D usefully provides a question bank for boards to use when tailoring a process more precisely suited to their needs. We were unsure as to the value of Appendix E, in our members’ experience, when businesses have material failings these are manifest across a number of business metrics and are easily identified, and we query the value of this new appendix.

Question 5 (page 6): 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?

The previous FRC consultation on this topic unhelpfully used the term “going concern” in two different ways, and Appendix B is reintroducing the same construction, although using the new term “solvency and liquidity risk”. If adopted as proposed, companies will risk creating confusion similar to that which we previously anticipated – simultaneously preparing their accounts on a going concern basis while stating in the Strategic Report that the business faces risks that could cause potentially significant solvency and liquidity consequences. The fundamental problem is the long-term nature of the proposals in Appendix B; the future is by definition uncertain and the further into the future one looks, the less confident one can genuinely be. We would strongly urge the FRC to reconsider its thinking in this area as few businesses could assert, with confidence, that they could survive through the general economic and specific business cycles (or the life cycles of their assets, which could run into decades) that they will not face solvency and/or

liquidity risks. We therefore believe that paragraph 9, read in conjunction with Appendix B, risks causing potentially damaging unintended consequences.

We have no doubt that the Sharman Report was anything other than a well-researched and reasoned piece of work. However, it does not necessarily follow that all of its recommendations have to be implemented as drafted. We would urge the FRC to reflect on whether the specific recommendation around the broader context of "going concern" is ultimately capable of being implemented, without potentially confusing investors trading on one of the world's most important stock markets as to the financial position of major enterprises with a London listing. To that extent, this proposal could be to the disadvantage of "UK plc" and reduce the attractiveness of London as a market for equity listings.

Question 6 (page 7): Do you agree with the guidance in Appendix C of the draft revised guidance? If not, how should it be amended and why?

Companies preparing financial statements in accordance with IFRS must be in compliance with IAS 1.25 with regard to their assessment of the appropriateness of the going concern basis and the disclosure of material uncertainties. It remains to be seen whether the IASB will amend IAS 1, but if they do so it will be following a due process which will make sure that there is an international consensus for any changes. Therefore, additional guidance from another body, which may be inconsistent with the requirements in the accounting standard, may introduce inconsistency in disclosure in the UK compared to other countries applying IFRS. Any changes to UK accounting standards should also be proposed following an appropriate due process.

The guidance in Appendix C introduces terms which are unfamiliar in relation to going concern assessment and disclosure but which have particular meanings in other context, such as "normal course of business" and "high level of confidence". Rather than directors assessing whether actions they may take would be considered to be within or outside the normal course of business, it would be better for them to concentrate on the exercise of appropriate judgement in providing disclosures about material uncertainties. Therefore, we suggest that Appendix C is withdrawn.

If retained, the last sentence of Appendix C is problematic in that it assumes that directors have included the risk giving rise to the material uncertainty about going concern in prior years' Strategic Reports. This seems likely to encourage companies to publish lengthy lists of all possible risks, rather than just the principal risks, to avoid the possibility that the risk giving rise to material uncertainty should reasonably have been identified.

We also note a typo in (b) at the top of page 22 and assume that "it" should read "if", should this appendix remain in the final guidance

Question 7 (page 7): Do you agree with the revised guidance? If not, what needs to be amended and why?

Given the broad composition of the GC100, we feel that others are better placed to offer views on this question.

Question 8 (page 7): Do you agree with the draft revised auditing standards? If not, what should be changed and why?

Given the broad composition of the GC100, we feel that others are better placed to offer views on this question.

Question 9 (page 10): 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?

We do not support the change to the Main Principle in C.2 as we would prefer to retain the word “significant” for the reasons previously argued.

While we support the concept underpinning the new Code Provision C.2.1, we do not support the proposed wording for three reasons – (1) we are unclear how a “robust” assessment differs from any other assessment, and would urge you to drop words that do not help create common understanding; (2) in line with our general comment, we would prefer to see reference to “material” and not “principal” risks here and (3) companies subject to the Code who are also registered with the SEC may have difficulty with the obligation to explain how risks “are being managed or mitigated”, given that the US regulator does not permit discussion of risk mitigation alongside descriptions of key risks. However, with work on the drafting we believe this provision will be a helpful addition to the Code.

In C.2.2 we believe the word “systems” should be added after the term internal controls. We would also recommend that “*all material controls*” be replaced with “controls in relation to significant risks” as the term used in the draft revised guidance is not one in common use or which can easily be interpreted.

Finally, we support the deletion of C.1.3. As noted in Appendix A, there are already two other sources of this reporting obligation (LR 9.8.6R (3) and IAS 1.25) and triplication is not necessary.

We would welcome the opportunity to discuss these points with you in greater detail.

Yours sincerely,



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GC100 Response to the FRC Consultation paper “Risk Management, Internal Control and the Going Concern Basis of Accounting”

Appendix – detailed drafting points

Paragraph 4: we would urge you to substitute “material” for “principal” in this context. As we noted earlier, most companies interpret the latter term as meaning “significant” which we doubt is what you intend here.

Paragraph 5: we do not believe that the board will be in a position to undertake this assessment, but it will be able to review management’s assessment. Also, within our working group, we were unclear how a “robust” assessment differed from any other assessment, and would urge you to drop words that do not help create common understanding.

Paragraph 9: please see our comments in the body of the letter in response to question 5.

Paragraph 10: please see our comment on paragraph 5 in relation to the word “robust”.

Paragraph 19: we feel that the FRC must distinguish between the role of the board and management. Our view is that the board should ensure that there is an effective process for the identification, assessment, management, monitoring and reporting of risk, but that it is management’s duty to design, implement and maintain that system (and we note that the FRC also makes this clear in paragraph 21). Also, in the third bullet we recommend that the work “principal” is replaced by “material”.

Paragraph 20: we do not believe that the board can be responsible for “*ensuring this distinction is understood internally*”, as this strikes us squarely as management’s responsibility. We would also recommend that the first line of this paragraph read “*The board’s specific responsibility for determining that the going concern basis of accounting is appropriate...*”.

Paragraph 21: we are unsure what levels of management are being referred to here, but assume that it does not extend down to all front-line supervisors. If this is the case, then this is clearly a duty that no board could easily perform.

Paragraph 22: again, we are unsure which employees are being referred to here. There needs to be some distinction between those who operate or form part of the control environment and those who do not, otherwise few companies could make the required assertion.

Paragraph 24: while we agree with the sentiment of the first bullet, we see it as impractical for the board itself to ensure that values and behaviours “*are communicated by management, incentivise the desired behaviours and sanction inappropriate behaviour, and assess whether the desired values and behaviours have become embedded at all levels*”, particularly where the levels of the organisation are not restricted in any way. We have similar concerns with the fourth bullet. We think it impractical for a board to “*specify the nature, source, format and frequency of the information that it requires on existing and emerging risks*”, though it will be able to review information provided by management. Likewise, in complex multinational enterprises, often comprising a number of different business segments or activities we think it unlikely that the board “*should understand the extent to which models have been used and their limitations, including key assumptions*”. Again, we would urge the FRC to consider the respective roles of management and the board.

Paragraph 25: we suggest that the word “significant” or “material” should be used in place of “principal”, depending on what the FRC’s intention is in this context (and in the heading of this

section likewise). When considering risk, it is important to assess the impacts both in the raw state (before any risk mitigation) and in the intended state (ie, assuming the relevant controls function as intended). This is the type of 'how' guidance which we think will be of benefit to boards and management.

Paragraph 27: we think the responsibilities of the board and management in relation to the assessment process have been reversed in the draft revised guidance. It strikes us as management's responsibility to design, implement and maintain the assessment process and report on its findings, and for the board to have oversight of that process and the reports which it generates.

Paragraph 28: again, we do not see this as the board's responsibility, though it would be entirely reasonable for it to require management to do these things.

Paragraph 31: we recommend that "material" is substituted for the word "principal" in the first bullet.

Paragraph 34: the list of points for consideration is helpful, but it is surely for management to develop the system, and for the board to review that system and the effectiveness with which it functions.

Paragraph 40: we are not sure what is meant by "*the effectiveness of the company's public reporting processes*". Presumably this implies that reporting is complete and accurate, but directors are already subject to legal and other obligations in this regard in relation to external reporting.

Paragraph 43: we feel that it is regrettable if the FRC objects to "standardised language", particularly if that wording has well understood meaning. The nature of much of the disclosure contemplated by the draft revised guidance (for example, how the review/assessment was conducted) is that it will be relatively static year-on-year for any given company, and likely to be very similar between companies. We fail to see how using established formulations of words, clearly understood by all, is to be avoided.

Paragraph 44: we believe that this obligation on the board requires some form of materiality qualifier if it is to be workable.

Paragraph 45: please see our previous comments on the word "robust". A number of FTSE100 companies are also SEC registrants by virtue of US listings, and expect that they will have difficulty in meeting the requirement to discuss how principal risks are being managed or mitigated. As you know, the SEC does not generally permit any discussion of these topics alongside descriptions of key risks and to meet the conflicting requirements of the US and UK regimes will be likely to have double disclosure of these items in their annual reports, creating unhelpful clutter.

Paragraph 47: please see our comment on paragraph 45 on the likely difficulty SEC registrants will experience with this requirement.

Paragraph 49: we are unclear whether the reference to "*ability to continue as a going concern*" should instead be a reference to "*ability to adopt the going concern basis of accounting*". This is a crucial distinction. Please also see our comments in the body of the letter in response to question 5, in relation to the broader question of companies' ability to stay in business throughout the economic and business cycles.

Paragraph 50: we question whether the terms "material" and "significant" are used correctly in this context.

Paragraph 57: we believe that the reference to “principal” risks should be to “material” risks.

Paragraph 58: please see our comments in the body of the letter in response to question 3.

Appendix B: we have substantial misgivings about the requirement to consider the solvency and liquidity risks facing the company over periods of longer than 12-18 months, as discussed in the body of the letter. We are concerned that few boards could give an unqualified assurance that their business could survive all of the potential uncertainties of the longer-term future, which will cause confusion to users of annual reports and, potentially, real economic harm to businesses who have chosen to list in London and are therefore subject to the Code.