Ernst & Young LLP
1 More London Place
London SE1 2AF

Tel: 020 7951 2000
Fax: 020 7951 1345
www.ey.com/uk

Building a better working world

INVESTOR IN PEOPLE

Catherine Woods
Financial Reporting Council
5th Floor, Aldwych House
71-91 Aldwych
London
WC2B 4HN

6 February 2014

Direct line: 020 7951 5485

Email: ahobbs@uk.ey.com

Via email: riskreview@frc.org.uk

Dear Ms Woods,

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

EY welcomes the publication of the Financial Reporting Council's (FRC's) consultation on *Draft Guidance to the Directors of Company's applying the UK Corporate Governance Code and associated changes to the Code* ("the draft guidance") and the opportunity to comment on the FRC's proposals.

EY welcomes and supports the FRC's revised approach to implementing Lord Sharman's recommendations. We believe that integrating guidance on solvency and liquidity risks with the *Going Concern and Liquidity Risk: Guidance for Directors (2009)* (the "2009 Guidance"); updated *Internal Control: Guidance for Directors (2005)* (the "Turnbull guidance"); and good practice guidance on risk management, chimes well with the Sharman Panel's recommendations. Such holistic guidance could, provided it is clear to users and practically focussed, help to link the related disclosures and enhance current reporting. We strongly agree that the management, assessment and reporting of liquidity and solvency risks should be an ongoing 'business as usual' matter and not something to be considered just because the board is preparing financial statements.

Our responses to the specific questions in the consultation paper are set out in **Appendix I** to this letter. In summary:

- In relation to the proposed changes to the **Corporate Governance Code** ("the Code") – *see response to Q9* - we support the additions. However, we believe that the going concern statement under C.1.3 is important for the users of the accounts and helps focus the minds of directors. Rather than delete the statement, we suggest that C.1.3. is reworded to relate more specifically to the going concern basis of preparation and the new disclosures.

- In relation to the **draft guidance**, our responses include a number of substantive issues. Our key overarching observations on the draft guidance can be summarised as follows:

  1. ***Does the guidance apply only to "principal" solvency and liquidity risks?*** *[See response to Q1]*

     Some parts of the draft guidance could be read as either applying to *all* solvency and liquidity risks or assuming that any solvency and liquidity risks will always be "principal risks" (e.g. paragraph 19 of section 2). However, most parts of the draft guidance refer to "principal solvency and liquidity risks" as defined in Appendix B (e.g. paragraphs 26 and 30 of section 4).

Many risks, if manifested beyond what is probable, will have an impact on liquidity and solvency, so we believe it is important to clarify:

- whether the guidance applies to all solvency and liquidity risks or just principal solvency and liquidity risks; and
- the extent to which boards should take account of probability when identifying principal solvency and liquidity risks.

2. ***Defining principal solvency and liquidity risks*** *[See response to Q5]*

For consistency, we suggest that a standard definition of "a principal risk" is used in both the draft guidance and in the Guidance on the Strategic Report. A single definition of "principal solvency and liquidity risks" should also be used throughout the draft guidance.

3. ***The introduction of the concept of "severe distress"*** *[See response to Q6]*

The draft guidance introduces a new concept of "severe distress", both to define principal solvency and liquidity risks and to help determine whether material uncertainties exist. It would be helpful if the FRC could articulate whether this concept is intended to change current practice, and lead to more material uncertainties being identified, or whether it is simply intended to help users identify whether principal risks and material uncertainties exist.

In our view, though, the clear focus when determining whether material uncertainties exists should be on whether the board has a high degree of confidence that the company is able to continue as a going concern for a period of at least 12 months from the date of signing the accounts. The concept of "severe distress" risks creating a distraction.

4. ***The "normal course of business"*** *[See response to Q6]*

In discussing the nature of "severe distress", the draft guidance states that "when the company would have no realistic alternative but to take significant actions outside the normal course of business to address the distress, this is usually symptomatic of it being severe". We believe that the additional guidance on the term "normal course of business" in Appendix C may give rise to confusion.

5. ***Explaining actions to remedy significant failings or weaknesses*** *[See responses to Q3]*

We recognise the concerns regarding boilerplate disclosure but have reservations regarding the proposed change as we are not convinced that the issues raised by the Turnbull Review Group, in their June 2005 report, have been addressed. However, if the FRC is minded to proceed, further guidance will be needed on the meaning of "significant", to help ensure consistency of reporting.

6. ***Improving the clarity of the draft guidance*** *[See responses to Q1, Q5 and Q6]*

   As well as the points above, to achieve the desired outcomes further work is needed on the structure, drafting and, in some cases, the level of detail in the draft guidance (in particular Appendices B and C). We have included in Appendix I to this response some suggestions for clarifying the guidance.

7. ***Articulating what has changed*** *[See response to Q1]*

   Finally, it is important that boards are clear on what has changed and what they need to do to comply with the draft guidance. Aspects of the draft guidance will seem familiar to users. As a result, it will be important: (1) to highlight what has changed in substance; and, (2) for the FRC to articulate its expectation about what boards need to do differently e.g. what does a board need to do to perform a robust risk assessment? The FRC may wish to consider using examples to illustrate.

- Finally, as regards the proposed changes to **ISA 570 (UK and Ireland) (Going Concern) and ISA (UK and Ireland) 700 (The auditor's report on financial statements)** – *see response to Q8* – we welcome the inclusion of materiality in relation to an auditor's consideration of whether there is anything to add or draw attention to in their audit report in relation to what the directors have included in the annual report and accounts in relation to solvency and liquidity risks and going concern.

  However, as a result of the proposed changes to the Code, the auditor's consideration of the matters relating to the robustness of the directors' assessment of the principal solvency and liquidity risks, including the related disclosures in the annual report and accounts, will be wider than the current consideration of "the directors' going concern statement" as the latter relates more closely to the audit of the financial statements.

  We believe that additional clarity will be needed about the responsibility of the auditor for considering the robustness of the directors' assessment of solvency and liquidity risks versus other general business risks.

We hope that our comments will be helpful. Should you wish to discuss our response in more detail, please do not hesitate to contact me.

Yours sincerely

Andrew Hobbs

Associate Partner, Corporate Governance & Public Policy

For and on behalf of Ernst & Young LLP

Enc.

Appendix I: Responses to specific questions

Q1: 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 agree that the *approach* taken in the draft guidance is appropriate to meet the FRC's objectives. However, to achieve the desired outcomes, we believe that further work is needed on the structure, drafting and, in some cases, the level of detail. We also believe that the use of definitions is necessary to help to resolve some issues of interpretation.

- ***Drafting***

  In general, most parts of the main body of the draft guidance have struck the right balance between detail and prescription - particularly the sections on internal control and risk management, which have been drafted in clear and "common sense" language. However, other parts need further work, in particular, Appendices B and C which are very detailed and not always well connected to the main body of the guidance.

  Some parts of the text are very wordy and dense. They would benefit from clearer drafting and signposting, by using headlines and diagrams. For example, to help directors understand what they need to do differently, a diagrammatic representation or flow chart could help explain how the broader risk assessment drives the outputs for the assessment of: (a) principal risks (including solvency and liquidity); (b) the management of principal risks; (c) the monitoring of internal controls; and, (d) the going concern assessment (including the identification of material uncertainties). The diagram could also illustrate how the outputs are linked to disclosures in the annual report.

  The 2009 Guidance is practical and very easy to understand for directors. Accordingly, more of it should be carried forward in a new Appendix. We say that because the accounting-related going concern aspects of the draft integrated guidance seem unduly light. In particular:

  - the 2009 Guidance contains more references to the requirements of applicable Accounting Standards and includes examples of how the Guidance could be applied to particular scenarios. We believe that examples of the application of the draft guidance would be very help.

  - Appendix II of the 2009 Guidance gives examples of going concern disclosures for companies other than small companies. It includes a focus on the particular factors that the directors need to consider in reaching a conclusion on the going concern basis of accounting – even when no material uncertainties have been identified. Absent such guidance, the focus on the principal risks disclosure in the strategic report could lead to a loss of valuable information and insight in the going concern disclosure.

- ***Should guidance apply only to "principal solvency and liquidity risks"?***

  As noted in our covering letter, some parts of the draft guidance could be read as applying to all solvency and liquidity risks or assuming that solvency and liquidity risks are always "principal risks" (e.g. paragraph 19 of section 2). However, most parts of the draft guidance refer to "principal solvency and liquidity risks" as defined in Appendix B (e.g. paragraphs 26 and 30 of section 4). We believe that it is important to clarify whether the guidance applies to all solvency and liquidity risks or only principal solvency and liquidity risks.

  Paragraph 6.50 of the Exposure Draft Guidance on the Strategic Report states that the principal risks in the Strategic Report "will generally be matters that the directors regularly monitor and discuss because of their likelihood, the magnitude of their potential effect on the entity, or a combination of the two."

  The draft guidance appears to identify principal risks based on their impact, irrespective of their likelihood, for example:

  - Appendix B defines the "principal solvency and liquidity risks" by relation to their likely impact "if" the risks materialise (rather than the probability of the risks materialising).
  - paragraph 30 of section 4 refers to whether or not the risks "would give rise to severe distress if they were to materialise."
  - paragraph 25 of section 4 requires the evaluations of "the likelihood of their incidence, and their impact if they were to materialise" after the principal risks have been identified.

  Many risks, if manifested beyond what is probable, will have an impact on liquidity and solvency, so we believe it is important to clarify the extent to which boards should take account of probability when identifying principal solvency and liquidity risks e.g. is 'tolerating' a risk (as per paragraph 26 of section 4) one of the options for the board?

  There is a risk that disclosures could become clouded by highly improbably risks, however, the risks of excess disclosure will need to be balanced against a consideration of the extent to which (if at all) probability is a valid basis for non-disclosure. For example, if a company were to determine that it had no principal solvency and liquidity risks, the enhancements introduced by the FRC's proposals, including the new disclosures, would not be effective. Therefore, if intention is to focus only on "principal" solvency and liquidity risks, the FRC may wish to consider whether companies should always have to make disclosures about solvency and liquidity risks - regardless of whether the risks are considered to be "principal" or "significant" – if only to explain why they are not significant.

- ***Articulating what has changed***

  Finally, as highlighted in the coving letter, it is important that boards are clear on what has changed and what they need to do to comply with the draft guidance.

  Aspects of the draft guidance will seem familiar to users. As a result, we believe it will be important: (1) to highlight what has changed in substance; and, (2) for the FRC to articulate its expectation about what boards need to do differently e.g. what does a board need to do to perform a robust risk assessment? We suggest that the FRC considers using examples to illustrate.

Q2. Do you agree or are more substantive changes to these sections [sections 5 and 6 of the draft guidance] required?

It seems to us that Sections 5 and 6 need to be amended to reflect all of the other changes in the draft guidance and the proposed revisions to the Code.

- In particular, the references in Section 6 to the annual assessment of risk management and the internal control systems do not provide sufficient guidance on all of the new issues identified in sections 2 to 4 of the draft guidance (such as, determining the board's risk appetite, establishing the framework for risk management and internal control and the identification and assessment of principal risk).

- Paragraph 40 (which addresses the annual assessment of risk management and the internal control system) has been updated by the addition of three new bullet points. However, the language is not well integrated with the rest of the draft integrated guidance. It needs to include, for example, more guidance on whether the processes for: (1) identifying and assessing principal risks; (2) setting the risk appetite; and, (3) establishing a risk management and internal control system that is suited to the company's circumstances (as described in paragraph 34 of the draft guidance), are themselves robust.

- We also believe that section 6 should be amended to reflect explicitly the new Code requirement for a robust assessment of principal risks facing the company (including principal solvency and liquidity risks). More guidance on the assessment process and what "robust" means in this context would also be helpful. This will be important both for directors, in complying with Code provision C.2.1, and for auditors, in complying with the proposed revised auditing standards (see our response to Q8).

- Code principle C.2 states that "The board should maintain sound risk management and internal control systems [our emphasis]". However, section 5 does not explicitly give guidance on what constitutes a "sound" risk management and internal control system. We think such guidance would be helpful to directors when making an assessment.

- New Code principle C.2 also states that "The board is responsible for determining the nature and extent of the principal risks it is willing to take in achieving its strategic objectives [our emphasis]". If the FRC wants to increase the specificity of companies' disclosures on how they apply this principle in practice (e.g. in setting their risk appetite), we think it could be helpful to include, in section 4, high-level guidance on setting risk appetites and, in section 7, some guidance and/or examples of how the risk appetite of the board and the risks it is willing to take should be disclosed.

Q3. The FRC would welcome views on this proposed change to the guidance [amending the guidance to recommend more explicitly that the board should explain actions to remedy significant failings or weaknesses].

As discussed in the covering letter, while we recognise the concerns regarding boilerplate disclosure, we have reservations regarding the proposed change and would ask the FRC to articulate why the issues expressed by Turnbull Review Group are no longer considered to be a problem.

Under extant Turnbull guidance, boards should have a process in place for identifying “significant control failings” but the assessment of what constitutes a ‘significant failing or weakness’ is made by the directors. The Turnbull guidance also requires a “board to confirm that necessary actions have been or are being taken to remedy any significant failings or weaknesses identified” from the annual review”. At present, this disclosure could be a high-level statement, in the Annual Report, that (unspecified) actions have been taken or are being taken. Indeed, in our experience, references to specific failings and weaknesses are only included in rare circumstances (and often only when a significant weakness is already in the public domain).

However, the Turnbull Review Group, in their June 2005 report[1], did consider whether further disclosure of actions was needed in the guidance[2]. The report had concluded that requiring disclosure of the necessary actions taken could be asking companies, in effect, to disclose material weaknesses – which would generate negative perceptions - and would also, in effect, require a definition of ‘significant control failing’ to enable consistency of interpretation. The Review Group did not think that such a definition was appropriate, on the basis that what is material or significant will depend on the company.

Therefore, if the proposed change to the guidance is made by the FRC, we believe that:

- preparers of accounts would need to understand the FRC’s expectations as regards the new disclosure e.g. is this a step change towards a Sarbanes-Oxley-type internal control statement, clarifying best practice or something in between?
- to seek to avoid “clutter” and seek to introduce a degree of comparability for users of financial statements, additional guidance on the term “significant failings or weaknesses” will be needed (c.f. the SEC’s ‘ Definition of the Term Significant Deficiency’). Such guidance would help create consistency of application. This is particularly important given the likely sensitivities and commerciality issues around a company disclosing information on actions that could indicate the nature of the significant control failings or weaknesses identified.

In particular, companies are likely to need guidance to help them benchmark the failings or weaknesses that are identified. For example on:

- the criteria for judging whether a failing or weakness is or is not significant and how it links to communication from the auditor (under ISA (UK and Ireland) 265, auditors are to report significant and other deficiencies in internal control)?

[1] https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Turnbull-review-evidence-paper.aspx
[2] See paragraphs 4.27 – 4.28.

- whether significant failings or weaknesses relate only to principal risks or, as appears clear from para 31 of the draft guidance, can they relate to other risks or the control environment generally?
- whether there is an expectation that all failings or weaknesses included in the auditor's report to the audit committee be included (on the basis that they were judged important enough to report)?

Alternatively, it occurs to us that the FRC might wish to give further thought to giving guidance that a company should always explain what if anything has been done as a result of the review. This would appear to address the FRC concern about boilerplate reporting but not require value judgements about the significance of the problems the actions were designed to address.

Q4. The FRC would welcome views on whether these appendices [Appendices D and E) are of use to directors and, if so, how they might be improved.

Appendices D & E are likely to be very helpful to directors. We have no suggestions, at this time, for improvement.

In passing, we would note that the references to accounting standards in Appendix A are restricted to IAS 1, whereas some Code companies may still apply UK GAAP.

Q5. 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?

See our response to Q1 for our general comments on drafting, which are applicable to Appendix B. We also wondered whether a risk diagram - showing the population of principal risks, principal solvency and liquidity risks, and what the draft guidance requires for these different types of risks in terms of risk assessment, going concern assessment and public reporting - would be helpful?

Our other comments are:

- ***Definition of principal solvency and liquidity risks***

  Appendix B defines the "principal solvency and liquidity risks" – the definition including the concept of "significant distress" (which is discussed in Appendix C). Paragraph 26 of section 4 also seeks to define, with a slightly differing wording, the nature of the risks that boards should identify. As noted in our covering letter, to seek to ensure consistency, we suggest that a standard definition of "a principal risk" is used both in the draft guidance and in the Guidance on the Strategic Report. In addition, a single definition of "principal solvency and liquidity risks" should be used throughout the draft guidance.

  As currently drafted, if the principal solvency and liquidity risks are as defined in Appendix B, it is unclear what are the other risks that might also give rise to severe distress would be in paragraph 30 of section 4. We believe that such ambiguity would be removed by defining the key terms used in the draft guidance.

- ***Stress testing***

  Although guidance on stress testing is not new, as the guidance integrates solvency and liquidity risks into a company's ongoing risk management system, we believe that additional detail, including practical examples, would be helpful particularly if guidance could be provided for specific sectors (e.g. retail, extractive industries, and pharmaceuticals).

Q6. Do you agree with the guidance in Appendix C of the draft revised guidance? If not, how should it be amended and why?

See our response to Q1 for our general comments on drafting, which are applicable to Appendix C. Our other comments, a number of which are also highlighted in the covering letter, are:

- ***Applicable requirements***

  We suggest that, to avoid confusion, Appendix C should focus first on setting out the requirements in accounting standards, company law and regulations such as the Listing Rules, on the accounting requirements, as regards both the going concern basis of accounting and material uncertainties (and related disclosures), and then set out guidance that may assist directors satisfy these requirements. The latter should include explicit guidance on how the going concern assessment relates to the assessment of solvency and liquidity risks described in Appendix B (including the review period).

- ***The introduction of the concept of "severe distress"***

  The draft guidance seems to us to introduce a new concept of "severe distress", both to define principal solvency and liquidity risks and to help determine whether material uncertainties exist. It would be helpful if the FRC could articulate whether this concept is intended to change current practice or whether it is intended simply to help users identify principal risks and material uncertainties.

  In our view, the clear focus when determining whether material uncertainties exists should be on whether the board has a high degree of confidence that the company is able to continue as a going concern for a period of at least 12 months from the date of signing the accounts. The concept of "severe distress" risks creating a distraction: in particular, the guidance on differentiating between actions taken within or outside the normal course of business risks, which we discuss below.

- ***The "normal course of business"***

  In discussing what constitutes severe distress the draft guidance states that it should be "a matter of judgement" for the board, but "when the company would have no realistic alternative but to take significant actions outside the normal course of business to address the distress, this is usually symptomatic of it being severe". The draft guidance then goes on to give examples of actions taken within and outside the normal course of business.

  The 2009 Guidance already refers to the normal course of business in relation to material uncertainties e.g. "The directors have concluded that a material uncertainty exists that casts significant doubt upon the company's ability to continue as a going concern and that, therefore, the company may be unable to realise its assets and discharge its liabilities in the normal course of business" which is consistent with the current ISA (UK&I) 570 'Going Concern'' paragraph 18 (unchanged in the FRC's proposed revisions to the ISAs).

We believe that the additional guidance on the term "normal course of business", relative to its usage in the 2009 Guidance, may give rise to confusion (e.g. as regards whether this is a new measure).

- ***Defining material uncertainties***

  Appendix C also contains a new, rebuttable presumption that risks "should usually be considered material uncertainties" in two specific circumstances involving distress and the company taking actions outside the normal course of business. In terms of the drafting, it is not clear why item (b) (on page 22 of the draft guidance) does not add (like (a)) "and the directors are not able to obtain a high level of confidence that such actions will be available to them and be highly likely to be effective".

  Page 6 of the consultation paper states, in relation to determining material uncertainties, that "Given that the Sharman Panel was concerned that there is not a common understanding in this area and that this was resulting in diversity of application, the FRC has concluded that there is a need for some clarification, pending further developments at the IASB".

  We would be interested to know whether the FRC envisages that the draft guidance will change how companies and their auditors determine material uncertainties (e.g. will comfort be harder to obtain)? If the aim of the draft guidance is to reduce diversity of interpretation, it may be helpful to include some illustrative examples (similar to scenarios 1 to 3 in the 2009 Guidance).

- ***Carrying forward of 2009 Guidance in connection with the going concern basis of accounting***

  We believe that significant amounts of the helpful 2009 Guidance should be reinstated e.g. practical guidance on how to carry out a going concern assessment for accounting purposes (if not incorporated into Appendix B). While the nature and extent of procedures required will always depend on the company's particular circumstances, the 2009 Guidance was more practical than the draft guidance in describing the types of procedures that directors must undertake in making a going concern assessment.

  There is also a danger that the focus on disclosure on principal risks (including solvency and liquidity risk) may mean less informative disclosure in the 'basis of preparation' concerning the going concern basis adopted (which can have a nearer term focus than some principal risks). For example, the illustrative disclosures on scenarios 1 to 3 in the 2009 Guidance have been helpful in improving the quality of disclosure in this area, in particular in scenario 2, where no material uncertainties were identified.

The 2009 Guidance also integrated the implications of particular going concern conclusions with auditor reporting, which may be helpful for directors to understand.

Q7. Do you agree with the revised guidance [Supplementary guidance to directors of banks]? If not, what needs to be amended and why?

As stated in our response to the previous consultation on implementing the requirements of the Sharman Panel, we agree with the position articulated in the supplemental guidance for banks. However, it seemed to us that the conclusion of the guidance reflects an implicit judgement on the degree of confidence that a bank (and others) will have central bank support. In practice the degree of confidence might change over time. The FRC may still wish to consider this in finalising the guidance.

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

The draft auditing standards would require the auditor to communicate to those charged with governance the auditor's views on the robustness of the directors' assessment of the principal risks facing the company, including those that would threaten its solvency and liquidity and its outcome, including the related disclosures in the annual report and accounts. Further, the auditor must consider whether, based on the knowledge acquired in the audit (including the evaluation of management's going concern assessment), he/she has anything material to add to or to emphasise in the auditor's report in relation to this communication, which has not been appropriately addressed in the audit committee report.

As noted in the covering letter, consideration of the "robustness of the directors' assessment of the principal risks facing the company" will be wider than the "the directors' going concern statement", as the latter relates might more closely to the audit of the financial statements. Therefore we believe that additional clarity will be needed about the responsibility of the auditor for considering the robustness of the directors' assessment of solvency and liquidity risks versus other general business risks. For example, considering the robustness of a board's assessment of principal risks could involve assessing whether the principal risks have been appropriately identified and are complete, whether the assessment process is appropriately robust, how the principal risks are managed and mitigated.

This is a similar issue to ISA (UK and Ireland) 260, paragraph 16(d) which requires certain communications to those charged with governance in relation to internal control. In that case, though, ISA (UK and Ireland) 260 makes it clear that this is "without expressing an opinion on the effectiveness of the entity's system of internal control, as a whole, and based solely on audit procedures performed in the audit of the financial statements".

Q9. The proposed revisions to Sections C.1 and C.2 of the Code are set out in full on the next page. 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.

As discussed in the covering letter, we support the proposed additions to Sections C.1 and C.2 of the Code. We do not, however, share the FRC's concern that the going concern statement in C.1.3 would be confusing and do not agree that it should be removed.

Going concern risks will be part of a wider risk management/assessment process and embedded in boards' governance processes. Nevertheless, we believe that the statement under C.1.3 will still be important for the users of the accounts and making the statement helps focus the minds of directors.

Hence, rather than delete the statement, we suggest that C.1.3 is reworded to relate more specifically to the going concern basis of preparation and the new disclosures.