Just Value Consulting

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

Response to FRC Consultation Document

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

Purpose of Response to the FRC Consultation

The FRC is hereby thanked for providing an opportunity to respond to its consultation in this critical matter. The purpose of this response is to provide oxygen in moving the development of this Regulatory aspect further than is in the consultation document. There are some fundamental matters that may need addressing, not just in the consultation document but indeed in the FRC's overall UK Corporate Governance Code. This is because the high-end, large corporate arena could be viewed as being in a combustible environment that could easily be ignited. The chaos of 2008 has been ostensibly brought under control although relative normality may not be fully restored.

The next worldwide conflagration e.g. that may be triggered by runaway financial and non-financial, real or synthetic derivatives may not end in such a positive manner. Therefore more radical, wider and deeper Regulation may be necessary. It has to be said that Governance in the top layer of ethical, highly performing corporates may be well ahead of the Regulatory curve. The large middle layer of corporates may be in need of some Regulatory guidance. However it is that very thin bottom layer of corporates (that may ignore the ethical element), that have caused all the major problems up to the present. Regulation may need to be formulated so that it can prevent that thin bottom layer from causing damage again by their potential toxicity. Current Regulation may not be identifying, addressing and countering that potential toxicity. More radical development of Regulation may be necessary to prevent the next conflagration.

Response Detail

Whilst acknowledging that the FRC as a Regulator cannot provide operational Leadership nor can the consultation document provide advice or be prescriptive, nevertheless the consultation document and the Combined Code appear to be lacking in directional Leadership in certain respects and, as a consequence, both may be somewhat one dimensional in nature. The 7 fundamental reasons for such a view are:

1) That the consultation document and Code in general Code fail to adequately address the critical area of appropriate Corporate Culture (Beliefs, Values, Thinking, Attitude and Behaviour). Instead, the focus is on Corporate Processes and Systems and just the “risk culture” in relation these areas which is merely a secondary component of Corporate Culture. It is likely that most corporate problems, disasters, failures and fatalities may be traced back to unacceptable Corporate Cultures, if the trouble was taken to carry out such reviews. Unacceptable Corporate Cultures can be the parents of risks as well as producing unacceptable and unsatisfactory processes and systems that cause corporate problems, disasters, failures and fatalities. It may be beneficial if the Corporate Culture aspect in relation to good Governance is not ignored but explicitly covered in the FRC’s Regulatory pronouncements & requirements. The 2008 worldwide financial crisis, precipitated by the Banks, is a seminal example where cause may be attributed to Corporate Culture failure rather than the secondary “risk culture” failure that Basel regulation aimed to cover.

   Constructive criticism without provision of concomitant solutions is a barren act. Accordingly, in this seemingly nebulous area (it really is not!) of Corporate Culture a clear, ethics based solution has existed for many years, without the wheel having to be reinvented. Thus, in the 7 Nolan Principles on Standards in Public Life there are at least 5 Principles that may have undeniable merit for inclusion in the FRC’s pronouncements and requirements. Such Principles should apply, not just to those senior individuals in public life but, also to those Boards of Directors, senior managements and others responsible for good Governance in commercial life and the private sector. The 5 Nolan Principles of Integrity, Objectivity, Accountability, Honesty and Leadership are clear candidates for inclusion in good Governance in the corporate sector. The remaining 2 of the 7 Principles i.e. Selflessness may not be entirely applicable where private capital is at risk and the last principle of Openness too may not be totally applicable as there may be issues of commercial sensitivity.

Simply reporting annually on the "certainty or uncertainty" aspect of "material risk" may address the symptom but not the cause of future corporate problems, disasters, failures and fatalities. Requiring the Boards of Directions to provide an affirmation that as many of the Nolan Principles that the FRC deems fit for purpose have been complied with **plus** the "certainty / uncertainty" aspect of "material risk" may be more efficacious. Such affirmation in the annual reporting should be in relation to not just the Boards of Directors and their managers but, critically remaining corporate personnel too. Failure to include this crucial element may result in pernicious corporate examples occurring repeatedly into the foreseeable future.

Furthermore, material failures in complying with the requisite Nolan Principles **and** the resultant consequences may be readily evident to Auditors. Therefore, if necessary, a requirement for them to report on such apparent shortcomings may prevent the onset of major corporate problems, disasters, failures and fatalities. Indeed if such corporate crises do arise when such declarations have been made and the Auditors have not reported on them then, such Boards and their Auditors would have been exposed again to practising empty rhetoric from an additional perspective.

2) That the consultation document and the Combined Code itself may be bland and retiring in giving direction on risk types. If risk types are mentioned, this occurs implicitly by simply alluding to economic risk. No attention appears to be given, implicitly or explicitly, to social risk and environmental risk. These are inasmuch the responsibility of good Governance as economic risk.

3) That the consultation document and the Combined Code itself primarily requires the organisation to be inward looking for risks to the organisation itself and only outward looking in relation to Shareholders. This is understandable in some respects as it concerns organisations on the Stock Exchange. However should not good Governance and Boards of Directors recognise that they have a responsibility to Stakeholders as well?? This does not appear to be present to any extent in the consultation document or the Combined Code with the inevitable consequences as set out in the next point.

4) That the consultation document and the Code itself should point out that good Governance and Board of Directors should be aware of their responsibilities to prevent "collateral damage" _ as has happened in virtually every instance of corporate problems, disasters, failures and fatalities to virtually everyone _ those in pension schemes, suppliers, customers *et al*. It is not just the protection of shareholders that should be the concern of the FRC as a responsible Regulator.

5) That neither the consultation document nor the Combined Code itself makes reference to Corporate Social Responsibility (CSR) requirements and reporting. Inclusion of such subject matter would provide a more "joined up" approach to promoting good Governance to the 350 UK Stock Exchange listed companies in this, the 21st century where challenges extend beyond the economic category.

In 2007 the United Nations ratified the Triple Bottom Line (TBL) standard, also known as the 3 Pillars of Profits, People and Planet, as the dominant approach for full accounting worldwide. The concept of TBL requires that a company's responsibility go beyond those of shareholders or owners of the business to anyone who is affected directly or indirectly by the actions of the company. The responsibilities of the company therefore go beyond maximising shareholder value and profit to also addressing the wider stakeholder interests.

In reporting terms TBL was preceded by the Global Reporting Initiative (GRI) which in 2002 was inaugurated as a United Nations Environment Program (UNEP) collaborating organisation by the then UN Secretary General, Kofi Annan. The Organisation for Economic Co-operation and Development (OECD) and the United Nations Global Compact are also in partnership in this area that has significant international exposure. Yet the FRC documents are deafeningly silent in this expanded and relevant area that good UK corporate Governance and reporting should address, if not in detail then, at least in affirmation terms.

There may be even great British companies with genuinely good Governance that probably adhere to most of the Nolan Principles, that may nevertheless still find that an apparent “money pot” can turn into a “money pit” if the Pillars of People and Planet are also not fully taken into account. The People example may be Tesco where it has closed its Fresh & Easy store chain in California with a loss exceeding circa £1billion. If the focus was more fully on People too then that may have disclosed that Californians store their food in massive chest freezers due to climate factors and therefore do not visit supermarkets with the frequency that consumers in the UK do. An obvious Planet example is another great British company BP and the multi-billion dollar liabilities it is facing in the Deepwater Horizon oil spill in the Gulf of Mexico.

6) Neither the consultation document nor the Combined Code itself makes reference to Whistleblowing matters even though the Public Interest Disclosure Act legislation on the subject was passed through Parliament at the turn of the millennium. Additionally, Public Concern at Work (PCaW) released the findings of its Whistleblowing Commission in November as a Code that calls for the Government, Regulators and the Courts to adopt its 25 recommendations and apply them in all UK workplaces. The Code calls for greater oversight of this area by Non-Executive Directors (and therefore Audit Committees). Following the very ethical and brave whistleblowing exploits of Michael Woodford the President and Chief Operating Officer at the Japanese corporate giant Olympus in exposing multi-billion pound losses, whistle blowing control measures have taken greater importance in the corporate world.

   Indeed by August 2013, the recently established Financial Conduct Authority Regulator has received nearly 5,000 calls on its whistleblower hotline. Yet the FRC consultation document and the Combined Code itself appear to be relatively silent in this area.

7) To come full circle, on the subject of Going Concern, both the consultation document and the Combined Code itself focus on the Known Knowns and perhaps the Known Unknowns but, more often than not, the cause of major

corporate failures can be the Unknown Unknowns, sometimes so-called just because they are the intangibles _ such as corporate culture. It is these so-called Unknown Unknowns that can be the “original sin” and the original source of risks to organisational Going Concern. Absence of this aspect in both the consultation document and the Combined Code itself keeps on providing that “non-stick layer of Teflon” to some Audit Committees and some Auditors until the next corporate crisis or fatality occurs. If the 7 points covered here are not addressed by the FRC this time round, hopefully the “non-stick Teflon layers” can be peeled away and genuinely improved Governance and Auditing can be implemented, incorporating all of these 7 areas, the next time a major corporate crisis or fatality occurs. This may happen due to the loopholes in requirements and reporting that may be currently present.

Concluding Comments

There is an increasing incompatibility between the model of indefinite economic growth (*videlicet* corporate profits) year on year, based on the ever increasing consumption of the world’s finite and ever decreasing resources. In such an environment it is not difficult to predict that unless good Governance, Risk Management and Regulation of corporate entities becomes better fit for purpose then, the incidence of corporate crises, failures and fatalities will increase and not decrease in the foreseeable future.

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