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11th February 2014

Dear Ms Woods

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

On behalf of KPMG in the UK, I am responding to the FRC's consultation, "Risk Management, Internal Control and the Going Concern Basis of Accounting".

We believe that the proposals are a sound basis for implementing the recommendations of the Sharman Panel. It draws a clear distinction between a forward-looking consideration and reporting of the financial and economic viability of the business model (the Sharman Panel referred to this as the "stewardship purpose") and the question of the basis of accounting and accounts disclosures (the Sharman Panel referred to this as the "financial reporting purpose"). Describing the narrative reporting requirements as reporting on principal risks and limiting the use of "going concern" to its widely used and understood meaning of the basis of accounting is, we believe, not only appropriate but critical. In our response to the Sharman Panel's Preliminary Report we stressed the need to distinguish the two.

We also support the consequent deletion of Corporate Governance Code ("the Code") provisions C.1.3 and would agree with the FRC's suggestion that the Listing Authority be approached with a view to removing the equivalent LR 9.8.6R(3). This is necessary to back-up the distinction and ensure that it is not misunderstood (something which the draft guidance rightly puts stress upon, eg at paragraph 20).

We also agree that it is right that the Sharman recommendations are implemented in guidance that also takes forward the FRC's risk management and internal control ("Turnbull") guidance. A key point arising from the Sharman recommendations is that, if companies are to be better managed, management of solvency and liquidity risks should be part of "business as usual" risk management systems and not a special one-off annual exercise.

With regard to carrying forward and revising the Turnbull guidance itself, the major proposal is the introduction of reporting of specific actions on internal control weaknesses. The sheer

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magnitude of such a change – tantamount to a kind of "super-SOX" – merits a fuller exposition of the pros (some of which are, of course, easy to see) and cons (in particular to identify potential unintended consequences). It would also require more in the way of practical guidance for directors than just the one paragraph proposed. We believe that it would be premature to make a decision on this important question on the basis of its comparatively light treatment in the consultation document.

Save for that open question, overall we support the proposed guidance and our answers to the consultation questions, set out in the appendix to this letter, focus very largely on drafting matters, albeit that we believe a number of these to be important if the guidance is to be capable of effective implementation.

Please do not hesitate to contact either Mike Metcalf (on 020 7694 8081) or me should you wish to discuss further any aspect of our response.

Yours sincerely

Tony Cates
Head of Audit

Appendix – The consultation questions

Set out below are our answers to the consultation questions (which we have numbered).

The draft guidance on risk management and internal control generally

Q1 – The FRC would welcome views on whether the draft revised guidance achieves these objectives [on page 3 of the Consultation Paper], and on the structure of, and level of detail in, the draft revised guidance.

We agree that the objectives in relation to internal controls should remain that stated in the 2005 guidance, reproduced on page 3 of the consultation. We note, however, that the revised guidance omits to give itself formal status as guidance for the application of Code provision C.2.1 (eg, in the way that Turnbull[1] did at paragraphs 11, 34-36).

Turning to the detail, we agree that it is right to address the issues in greater depth. We also believe that it is important to ensure that nothing useful is lost in the move from the two sets of existing guidance to the proposed new guidance.

Whilst incorporation of the 2009 guidance[2] naturally means that some of its material cannot be carried forward, we note several key areas that, at the least, we believe should be retained, for example:

- Paragraphs 15 and 16 (2009) gave useful guidance on the important question of refinancing at the time of a deleveraging banking system. These paragraphs were vital in 2008/09. They were the key development that the FRC saw the need for and rightly acted to bring about. We believe that it would be inappropriate to lose them.
- Paragraph 66 (2009) guidance explains the reasons for the accounts to use the phrase "material uncertainties that...", when such uncertainties exist. We strongly believe that this should be retained. It is right that the accounts should use those words set out in the accounting standards and, as rightly stated by the 2009 guidance, use of these words avoids over the problem of a qualified audit report for inadequate disclosure.

We believe that these are particularly important. More generally we believe that the old guidance contained practical material for directors in relation to, eg, liquidity. We recommend that the FRC should take a detailed inventory of the 2009 guidance to ensure

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1 Internal Control: Revised Guidance for Directors on the Combined Code (2005)
2 Going Concern and Liquidity Risk: Guidance for Directors of UK Companies (2009)

that other relevant information is not lost and provide a commentary on its rationale for eliminating existing guidance, which has, in the main, worked well to date.

Whilst the major change of principle on internal controls is that addressed at question 3, we believe that the detail of the 2005 Turnbull guidance should also be carefully considered by the FRC to ensure that useful, practical material is not lost. This is particularity important as the Turnbull material has not, unlike the going concern material, been the subject of extended public consultation.

Establishing and reviewing the risk management and internal control systems

Q2(a) – Do you agree or are more substantive changes to [section 2 of the draft revised guidance] required?

We do not believe that fundamental changes are required to section 2.

Q2(b) – Do you agree or are more substantive changes to [section 3 of the draft revised guidance] required?

We are concerned that the penultimate bullet of paragraph 24 could be read as a suggestion that the board can delegate its *responsibilities* to committees. Whilst aspects of the review work may be delegated, the board, as a whole, retains full responsibility. We believe that, rather than the board being satisfied that "the arrangements for the work carried out by the committees … and for reporting to the board are appropriate and operating effectively," the board, as a whole, should form its own view after due consideration of committee recommendations. In the same way, it would be worth emphasising in the last bullet that sources of assurance, however valuable they are, do not lessen the board's responsibility either.

We agree that capital should be a board discussion item (second bullet of paragraph 24). However, it is not clear to us as to what boards to are being asked to focus on: assessing how much capital the strategy and risks require, building it up through profit, raising it externally, or the "message" of an inability to get capital providers on board? The bullet does not enlarge on this (its subject is largely performance), whereas it would be helpful – particularly for those outwith the financial sector – if it did so. That would also set the context for the term when it recurs in paragraph 40 (section 6).

Finally with regard to section 3, we also suggest that paragraph 23 should refer to ensuring that informed debate and constructive challenge actually take place (rather than only being possible and encouraged).

Q2(c) – Do you agree or are more substantive changes to [section 4 of the draft revised guidance] required?

The new guidance rightly has as an aim that boards should have more potential causes of severe stress on their risk management "radar". The practical challenge for boards is that when asked to look at anything that could cause severe distress, the list could be very long and include some very unlikely matters; so where do they draw the line (particularly in the case of high impact, low probability events)?

It is not possible, of course, for the guidance to provide an easy answer for boards. However, the guidance could aspire to provide more assistance than at present. For example, paragraph 26 is a clear statement (or definition) of the principal risks: it is those risks or combinations of risks that can seriously affect future performance; it has no sense of a limit or boundary as to how far one goes; or of how one decides what combinations of unrelated risks one should plan for. Paragraph 25, on the other hand, has a conflicting message, *viz* that boards should consider the likelihood of occurrence when identifying principal risks. Even this, however, does not assist the combination issue or indicate any qualitative basis for low likelihood cut-off. Is the proposition that boards should determine their own cut-off and then disclose all those risks, or combinations of risks, that they have considered, thereby letting shareholders judge for themselves whether their board has chosen the right approach?

We see this as the major remaining issue with the "Sharman" element of the draft guidance. After all, it is rightly asking boards to do more to expect the unexpected. By definition that is something that no board can do perfectly. So the more that the FRC can do to help boards to do it reasonably well, the more useful the guidance will be and the more successful the reforms will be.

Q2(d) – Do you agree or are more substantive changes to [section 5 of the draft revised guidance] required?

We do not believe that fundamental changes are required to section 5.

Q2(e) – Do you agree or are more substantive changes to [section 6 of the draft revised guidance] required?

Paragraph 40 refers to issues that may have "a material impact on the company's performance or reputation". Why has reputational risk been singled out for inclusion as a distinct item? The strategic report regulations[3], and the old business review legislation set the requirement and use the familiar phrase, "to the extent necessary for an understanding of the development, performance or position of the company's business". This is essentially what the draft deals with when it refers to "performance" (though, oddly, the draft has truncated Turnbull's "performance and condition", which was more consistent with the law).

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3 The Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013, SI 1970/2013

The implication of the additional, "or reputation", is not clear. Reputational consequences that affect the future performance are already covered. Reputational issues that do not affect future performance seem to have little value and little basis in the legislation.

Statement on the effectiveness of the risk management and internal control systems

Q3 – The FRC would welcome views on this proposed change [in paragraph 58] to the guidance.

This proposal – to "explain what actions have been or are being taken to remedy any significant failings or weaknesses identified from [the board's] review" – is a very significant one, and it is not difficult to see its value to shareholders.

Take the case of two otherwise identical companies, both exposed to exactly the same, as yet uncrystallised risk. One company has controls in place to manage that risk effectively and the other lacks such controls. Shareholders would be better able to distinguish the two companies and hold to account the directors of the second.

It might be argued that this is the single most significant change in internal control reporting since the original Turnbull guidance in 1999, if not before that. It amounts to the disclosure of specific internal control weaknesses. After all, one cannot report a specific action on a weakness without at the same time making apparent the weakness itself. Further, this applies to any internal control weakness and not just those in connection with financial reporting. It may be tantamount to a "super-SOX".

That leads to two points. First, the sheer magnitude of the change merits a fuller exposition of the pros and cons, laid before consultees, than is contained in this consultation document. Second, it also merits practical application guidance for directors. That is not to say that there should be some kind of complete code of rules obviating any need for judgment. However, there needs to be *something* (as it would be the "biggest thing" since Turnbull itself) and at present the draft contains no further guidance. Without those two matters being addressed, we believe that it is premature to decide this key question one way or the other.

Finally, we note that it would be necessary to change to Code to reflect this too. At present there is nothing in the Code to underpin this major new component of reporting. It does not have any "comply or explain" backing.

Questions for the board, and warning signs

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

We believe that appendices D and E will be of use to directors. However, we note the following:

- The sixth bullet within "risk management and internal control system" should ask, "how is the board satisfied ..." rather than, "is the board satisfied ...", since this is a question of sufficiency and not a binary answer.
- The first bullet within "public reporting" should ask, "how has the board satisfied itself that the disclosures on risk and internal control contribute to the annual report's being fair, balanced ... and providing shareholders with the information ...", as the "fair balanced etc" standard applies to the annual report as a whole, which covers much more than the scope of this guidance.
- The second bullet within "public reporting" will be applicable only with a material uncertainty in the accounts. Adding, "where appropriate, is there a ...", would resolve this.

Assessing solvency and liquidity risks

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?

As we said earlier, we agree with the distinction that is restored between a forward-looking consideration/ reporting of the financial and economic viability of the business model (the principal risks) and the question of the basis of accounting/ accounts disclosures. We think, however, that there is some drafting where the distinction is still blurred. Thus, the second paragraph of appendix B would be better phrased as, "... assessing the appropriateness of the going concern basis of accounting and any material uncertainties about its appropriateness." The third paragraph should also refer to, "... these aspects of the going concern basis of accounting ...". (We comment on other instances under question six.)

Having set out that contrast (subject to our comments), this appendix is chiefly concerned with the assessment of solvency and liquidity risk from the point of view of managing and reporting the principal risks. Our second main concern with this appendix is that it is not clear on the time horizon. We fully agree that it should look out a long way. However, there is no clear statement of guidance for directors on that point. The principal paragraph here is the eighth, with its menu of different time periods. Which one applies? If they apply in different circumstances, then in what circumstances? At the same time there are statements

that the period depends on business planning and the quality of information available (the eighth and ninth paragraphs); this seems likely to entrench existing standards of planning and information quality, whereas the guidance is intended to drive improvements in those.

In terms of other, more detailed points:

- The first paragraph of Appendix B refers to solvency and liquidity risks. Paragraph 30 of the draft guidance refers to solvency, liquidity and "other" risks. We assume that appendix B is correct and that paragraph 30 requires amendment.

- We understand the intention of the final sentence of the fourth paragraph ("it is important ..."): if a company has difficulty attracting capital then that is a "wake up call" for the directors about the viability of the business model. However, the drafting is not clear and may be mis-read as a hint to avoid disclosure if such disclosure would mean capital providers are less willing to offer funding – clearly an inappropriate outcome.

- As noted in our responses to previous related consultations, the distinction between solvency (in simple terms having assets in excess of liabilities) and liquidity (having the liquid resources, usually cash, to meet liabilities as they fall due) may not be easy for those outside the financial sector, compounded by the fact that most insolvencies (in the familiar, statutory sense of the word) are a result of liquidity failures.

- The sixth paragraph is unclear about the directors' standard of care when making the assessment. Presumably the intention is to explain the statutory standard of section 174 of the Companies Act 2006, it is about what the director actually knows, *but not less than* what he ought reasonably to know.

- The distinction between stress and sensitivity tests is not made clear by the tenth and eleventh paragraphs. Does the FRC intend these tests to be different (they both involve varying the assumed future conditions) or for them to be used for different purposes?

Reporting on the going concern basis of accounting

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

Material uncertainties

In the main this appendix addresses three questions: i) what is a material uncertainty; ii) what is severe distress (on which (i) depends); and (iii) what is normal (on which (ii) depends)? It

would benefit from restructuring as a sequence of three key propositions, clearly identified as such, with separate supporting material on each. As currently drafted there is some lack of clarity in this respect, including contradictory statements.

In terms of that detail, we begin with material uncertainties. Of several statements on this the most comprehensive and therefore, we assume, the intended definition, is in the tenth paragraph: that there is usually a material uncertainty if either there is currently severe distress but not a high level of confidence that non-normal course actions will be available and highly likely to be effective, or there will be severe distress in the twelve months from approval of the accounts. We have the following observations about this:

- Is the ambiguity ("usually") intended? Given that the rest of the definition relies on subjective concepts, it may be better, in terms of consistent application, to remove this extra wrapper of ambiguity.

- There has to be a high level of confidence that mitigating actions will be highly likely to be effective. Should it refer to a high level of confidence that mitigating actions will be effective (since high probability times high probability does not make a high probability)?

- In the second limb of the test, the drafting implies a requirement for certainty of severe distress over the following twelve months ("will ... give rise"). Is certainty the intention? If not, what level of likelihood is intended?

- In the second limb of the test, there is no provision for taking into account mitigating actions. We trust that this is *not* intended.

Once this definition of a material uncertainty is settled, all other references need to become consistent with it. Further, to the extent that such references do no more than repeat the definition, rather than helpfully supplement it, they are redundant and should be deleted. We have noted the following other references:

- The eleventh paragraph states there is no material uncertainty if the likelihood of not "continu[ing] as a going concern" is remote. A remote chance of failure is not necessarily the counterpart of a high level of confidence of success. In fact, we believe that the latter is possible notwithstanding some non-remote chance of failure.

- Appendix B's seventh paragraph (probably misplaced in B) states that without "a high level of confidence that solvency and liquidity risk can be managed effectively during at least the twelve month period from the date of approval of the financial statements ... is likely to have a going concern material uncertainty to disclose". Here the second limb of the test includes probability and mitigating actions, which are left out by the tenth paragraph of appendix C. It also extends the look forward to the familiar "at least" formula. We trust that at least some change to appendix C is required. We also

note that B and C use different words for their wrap-around ambiguity – "highly likely" vs "usually" – but see our earlier comment on that.

- The second paragraph states, equivocally, that even if there are material uncertainties, one *might not* depart from the going concern basis. This implies an alternative of material uncertainties with departure from the going concern basis – ie,, a material uncertainly when there is no realistic alternative to liquidation or ceasing to trade. That is mistaken; there is no uncertainty in such a case.

- That same paragraph also refers to a high level of confidence of mitigating a situation so as to enable the company to avoid liquidation or cessation of trade and says that there may still be a material uncertainty. This is inconsistent with the definition.

Severe distress

We wonder whether the term "severe distress" is one Russian doll too many. When all the dolls are opened, a material uncertainty exists when one cannot be highly confident that there is no need to take abnormal action or that, if such actions are needed, they will be effective in addressing whatever it was (undefined) that caused that need. This can be stated without using the term, "severe distress", which seems to serve only as a connecting term between "material uncertainty" and "normal course".

So the term might be safely dispensed with and the guidance made somewhat shorter and more direct. On the other hand, omission lays bare the inherent circularity, *viz*: there is a material uncertainty if one cannot be highly confident that abnormal action will be successful in resolving whatever caused one to take abnormal action – this does not say anything as to what the cause might be. Presumably it is solvency and/ or liquidity risks. Again, this could be said without the intermediate term "severe distress".

Abnormal actions

What is or is not in the normal course of business is, however, quite clearly a substantive proposition. We agree that this is a judgmental matter and cannot be closely defined, and we believe that for the most part directors and auditors would be able to make the distinction. We have a concern, however, that some of appendix C may actually be unhelpful:

- The fifth and sixth paragraphs seem to equate normal with contingency plans and abnormal with crisis management. We suspect that some contingency planning may be quite close to crisis management. Moreover this makes a distinction based on degree of prior planning, such that two companies facing the same crystallised risk do not necessarily both report a material uncertainty. We foresee these paragraphs creating unnecessary debate in application.

- The examples of normal *vs* abnormal are so clear cut and incontrovertible as to be unhelpful. Unaccompanied by more difficult cases – eg, suspension of dividends, deferral of capital expenditure, renewed focus on restructuring the cost base – they may inappropriately encourage abnormal as meaning extreme actions. Incidentally, we also note that a heavily discounted, underwritten rights issue, though abnormal, would not lead to a material uncertainty if the underwritten amount were sufficient to give high confidence of solving the crisis.

- We do not understand the references to the implications of actions on shareholders, "creditors and other stakeholders" (eighth and ninth paragraphs). Material uncertainty disclosure is about an accounting judgment – appropriateness of the use of the going concern basis of accounts prepared for shareholders. No duties in relation to those accounts are owed to creditors or undefined others. This is a rather fundamental point, and so if the FRC has a scenario in mind where the case may be different, it should have been consulted upon, and we do not believe that it would be appropriate to take it forward without doing so.

Maintaining the distinction of narrative risk/ business model reporting and the going concern basis of accounting

As we have said earlier, we agree with the distinction that has been drawn. However, it has incompletely carried though into appendix C, principally in the eighth paragraph (plus ninth, eleventh and paragraph 50 of section 7). We see no difference between that paragraph's stated purpose of material uncertainty disclosure, being the forewarning of threats or risk, and narrative reporting of risks to the business model.

Instead, these paragraphs should (as rightly set out in proposed Code provision C.2.1) explain that material uncertainty disclosure is a disclosure about uncertainty as to the appropriateness of an accounting judgment, *viz* to use the going concern basis for the accounts. Whilst this leads to disclosure of an uncertainty as to whether there is a realistic alternative to liquidation/ cessation over the look-forward period, nevertheless the purpose of this disclosure is not risk for its own sake, which would be risk reporting pure and simple, but because of its potential effect on the current set of accounts.

Reporting

Paragraph 51 of section 7, and part (a) of the twelfth paragraph of this appendix, require that in *all* cases when the going concern basis is used it should be explicitly stated to be so. This is not required by accounting standards (albeit paragraph 51 might imply that it is) and we should not support a new requirement for such boiler plate disclosure.

We also note that part (c) of the twelfth paragraph deals with the case where, "the going concern basis of accounting is not appropriate," but only requires that the board "if

appropriate, adopt a liquidation basis" – seemingly allowing the adoption of the going concern basis despite its inappropriateness.

Banks

Q7 – Do you agree with the revised guidance? If not, what needs to be amended and why?

Fundamental changes are required in relation to banks. The concepts applied at banks should be the same as those at other companies, with this supplement rightly addressing the sector-specific issue of whether central bank liquidity support is part of the normal course of business and so no material uncertainty exists.

We believe that the guidance on that point (paragraphs 52-55) is appropriate, albeit that it may not be straightforward to obtain the necessary high level of confidence. It may require the "at least" twelve months to look out further than usual and it will be critically dependent on the prudential regulator's openness with directors and auditors. We also observe that these conditions may not be met when the liquidity support is intended to allow time for the bank to restructure its operations or finances. Is that the FRC's and the PRA's intention?

We note that the conclusions in paragraphs 53, 54 and 55(a) are stated in terms of the bank's remaining "viable for the foreseeable future". We believe that they should be in terms consistent with paragraph 51's question, which they answer, *viz*: that such reliance is in the normal course of business and so would not signal a material uncertainty.

We also notice that paragraph 59 states that if one is unable to conclude that there is not a material uncertainty, then one "might" conclude that material uncertainty disclosure is required. This implies that, alternatively, one might not. We assume that this is unintentional.

Finally, the last sentence of paragraph 62 sets an expectation that directors and auditors might decide that public disclosure is required for "other reasons". There is neither explanation of these reasons nor any case set out for why such an expectation should be put in place.

Auditing

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

We continue to support the FRC's ambition that auditors should report on the directors' narrative reporting on the principal risks specifically in the area of solvency and liquidity, ie on their statement under proposed Code provision C.2.1, based on existing audit knowledge.

We have concerns about the detailed drafting, however. We suggest that ISA 700 be re-drafted as a new sub-paragraph of 700.22B along the same lines as existing 700.22B(a), eg:

> "a statement by the directors that the board has carried out a robust assessment of the principal risks facing the company, including those that would threaten its solvency or liquidity, also explaining how the principal risks are being managed or mitigated, that is inconsistent with the knowledge acquired by the auditor in the course of performing the audit."

Consequential changes would also be required to ISA 570.17-3

We ask this because the current drafting confuses this exception reporting on the C.2.1 statement with the other exception reporting and with an emphasis-of-matter (EoM). The other exception reporting in ISA 700.22A, 22B is in terms as suggested above, whereas the FRC has proposed that the auditor report on C.2.1 in the following terms: that he has nothing to add or draw attention to with respect to the directors' statement. Since the basis for the auditor's conclusion is the same in all cases, it is confusing to report them in different terms, especially when the proposed report under ISA 700.22C (and 570.17-3) could be read as more than the negative assurance that it really is.

The confusion with an EoM arises because draft ISA 570.17-2, 17-3 and ISA 700.22C are in terms of "draw[ing] attention to" and emphasis[ing]", which are terms used by ISA 706 when describing the function of an EoM.

We also note that at various places in the the ISAs the distinction between the going concern basis of accounting and risk reporting has not been carried through. Please see ISA 260.A20-6 (last bullet) and ISA 570.17-2, 17-3. Lastly, we believe that the first bullet of ISA 570.A20-6 uses a different explanation of principal risks from that in paragraph 26 of the draft guidance.

Changes to the UK Corporate Governance Code

Q9 – The FRC would welcome views on whether the additions are required [to the proposed revisions to Sections C.1 and C.2 of the Code] 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 agree that provision C.1.3 should be removed. If it were not removed then it would need to be modified to make clear that it is seeking a statement that (if it is the case) the going concern basis of accounting has been adopted and whether there are or are not any material uncertainties as to the appropriateness of that accounting judgment.

In addition we support the deletion of the equivalent text within LR 9.8.6R(3). The FRC will need to pursue that with the Listing Authority, and the time required for the Listing Authority to make changes should not be underestimated; after all, the Listing Rules still do not refer to the FRC's September 2012 Corporate Governance Code. If that Listing Rule were retained, then this guidance should make clear that LR 9.8.6R(3) refers to going concern basis of accounting.

We support the inclusion of new Code provision C.2.1 and the revisions to what is now Code provision C.2.2:

- New provision C.2.1 reflects the board's broader responsibilities for risk management and internal control, as is addressed in more detail in the revised guidance and should, we agree, ask boards to explain how the principal risks are managed or mitigated.

- The changes to provision C.2.2 emphasise the distinction between the board's ongoing monitoring of the risk and internal control system and the formal annual review of the system's effectiveness. We believe this was always the intention of the Code and guidance, but the clarification is useful.

As we noted in our answer to question 3, if the FRC is to introduce reporting of specific actions on internal control weaknesses, then we believe that provision C.2.2 would require further amendment.

Finally, we suggest that the FRC reviews its *Guidance on audit committees* to consider whether consequential changes are needed to that.