Consultation Paper

Financial Reporting Council

November 2013

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

Consultation on Draft Guidance to the Directors of Companies applying the UK Corporate Governance Code and associated changes to the Code

The FRC is responsible for promoting high quality corporate governance and reporting to foster investment. We set the UK Corporate Governance and Stewardship Codes as well as UK standards for accounting, auditing and actuarial work. We represent UK interests in international standard-setting. We also monitor and take action to promote the quality of corporate reporting and auditing. We operate independent disciplinary arrangements for accountants and actuaries; and oversee the regulatory activities of the accountancy and actuarial professional bodies.

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SECTION 1: Introduction and overall approach; how to comment

In January 2013 the FRC consulted on how best to implement Lord Sharman's proposals on going concern[1], published in 2012. It announced at the same time that it intended to consult on an updated version of ‘Internal Control: Guidance to Directors’ (often referred to as the “Turnbull Guidance”), which was last updated in 2005.

In light of the responses to the January consultation, the FRC announced in June that it was considering a different approach, which would aim to.

- Make a clearer distinction between the meaning of going concern in the broad context meant by Lord Sharman and how it was used in accounting standards. The feedback highlighted that using the phrase “going concern” to describe both the specific assessment required when preparing the financial statements, and the broader assessment of the risks affecting a company’s viability, was confusing; and
- Make a clearer link between the assessment of business viability risks and the broader risk assessment that should form part of a company’s normal risk management and reporting processes.

The FRC has concluded that the best way to address these issues is to integrate its current guidance on going concern and risk management and internal control, and to make some associated revisions to the UK Corporate Governance Code (“the Code”). This consultation seeks views on the proposed approach and the draft revisions to the Code and guidance. The intended audience for this guidance is companies that apply the Code, either because they are required to (for example, companies with a premium listing of equity shares in the UK) or choose to do so voluntarily.

In response to concerns raised in response to the January consultation, the FRC is preparing separate, simpler guidance for other companies, on which it will begin consultation in the near future.

For companies that apply the Code, the FRC considers this approach both reflects the recommendations of the Sharman report and its ‘Boards and Risk’ report, published in 2011. Lord Sharman concluded that the assessment of the threats to a company’s solvency and liquidity should be broadly based. Similarly, the FRC’s report highlighted that the board’s responsibilities for risk management and internal controls are not limited to the oversight of the internal control system. Taken together, the conclusions of the two reports can be summarised as:

- The board must determine its willingness to take on risk, and the desired risk culture within the company;
- Risk management and internal control should be incorporated within the company’s normal management and governance processes, not treated as a separate compliance exercise;
- The board must make a robust assessment of the principal risks to the company’s business model and ability to deliver its strategy, including solvency and liquidity risks. In making that assessment the board should consider the likelihood and impact of these risks materialising in the short and longer term;

[1] The reports of the Sharman Panel Inquiry into going concern and liquidity risks can be found at: http://www.frc.org.uk/Our-Work/Headline-projects/The-Sharman-Inquiry.aspx

- Once those risks have been identified, the board should agree how they will be managed and mitigated, and keep the company's risk profile under review. It should satisfy itself that management's systems include appropriate controls, and that it has adequate sources of assurance;
- The assessment and management of the principal risks, and monitoring of the associated controls, should be carried out as an on-going process, not seen as an annual one-off exercise; and
- This process should inform a number of different disclosures in the annual report: the description of the principal risks and uncertainties facing the company in the strategic report; the disclosures in the financial statements on the going concern basis of accounting and material uncertainties thereto; and the report on the review of the risk management and internal control system.

The FRC has decided to bring together its guidance on these matters in one place to encourage boards, as part of the same broad on-going process, to consider risk identification and management, including the assessment of solvency and liquidity risks, and to determine whether the company is able to adopt the going concern basis of accounting. The structure and content of the guidance are explained in sections 2 and 3 of this consultation document; the draft revised guidance itself is set out in the Appendix.

The draft guidance would replace 'Internal Control: Guidance for Directors' (2005) and 'Going Concern and Liquidity Risk: Guidance for Directors' (2009). Subject to consultation, the intention is to publish the revised guidance in the first half of 2014 to take effect simultaneously with proposed changes to the Code.

The FRC also considers that changes to the UK Corporate Governance Code may be needed. The proposed changes to the Code, and the rationale behind them, are set out in section 4 of this document. Any changes resulting from this consultation would be incorporated in a revised edition of the Code that, together with the revised guidance, would apply to reporting periods beginning on or after 1 October 2014.

How to respond

Comments on the questions set out in this consultation document are requested by 24 January. Responses should be sent by e-mail to riskreview@frc.org.uk, or in writing to:

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Aldwych House
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It is the FRC's policy to publish on its website all responses to formal consultations unless the respondent explicitly requests otherwise. A standard confidentiality statement in an e-mail message will not be regarded as a request for non-disclosure. The FRC does not edit personal information (such as telephone numbers or email addresses) from submissions; therefore only information that you wish to be published should be submitted.

SECTION 2: Guidance on risk management and internal control

The FRC considers that 'Internal Control: Guidance for Directors'[2] needs to be updated whether or not it is integrated with guidance replacing 'Going Concern and Liquidity Risk: Guidance for Directors'.

The section on risk management and internal control in the UK Corporate Governance Code was updated in 2010. Economic developments and some high profile failures of risk management have resulted in greater attention being paid to the role of the board in determining the company's approach to risk. The FRC's 'Boards and Risk' report, published in 2011, highlighted the board's responsibility for setting the desired values and behaviours, and assessing and monitoring principal risks.

The related guidance was last updated in 2005. Its aim was to: reflect sound business practice whereby risk management and internal control is embedded in the business processes by which a company pursues its objectives; remain relevant over time in the continually evolving business environment; and enable each company to apply it in a manner which takes account of its particular circumstances.

The primary focus of the current guidance, reflecting the content of the Code at that time, is the board's role in establishing and monitoring the effectiveness of the internal control system. There is some reference to the board's other responsibilities for risk, in particular that "In determining its policies with regard to internal control, and thereby assessing what constitutes a sound system of internal control in the particular circumstances of the company, the board's deliberations should include consideration of the following factors:

- the nature and extent of the risks facing the company;
- the extent and categories of risk which it regards as acceptable for the company to bear;
- the likelihood of the risks concerned materialising;
- the company's ability to reduce the incidence and impact on the business of risks that do materialise; and
- the costs of operating particular controls relative to the benefit thereby obtained in managing the related risks".

The draft revised guidance seeks to address these aspects of the board's responsibilities in more depth. ***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.***

Sections 2 to 4 of the draft revised guidance elaborate on the references in the current guidance, and respectively address the board's responsibilities for managing the principal risks facing the company, the factors that boards should consider in order to exercise those responsibilities effectively, and how risks are assessed.

Sections 5 and 6 of the draft revised guidance address the design and process for reviewing the risk management and internal control system. They are largely unchanged from sections 2 and 3 of the current guidance ("Maintaining a sound system of internal control" and "Reviewing the effectiveness of internal control"), which the FRC considers remain fit for purpose. ***Do you agree or are more substantive changes to these sections required?***

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[2] The current version of the guidance can be found at: http://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Corporate-Governance-Code/Guidance-for-boards-and-board-committees.aspx

Section 7 of the draft revised guidance concerns the information boards are expected to disclose in the annual report and accounts. It covers reporting on principal risks and uncertainties in the Strategic Report – the text of this section is consistent with that in the FRC's draft guidance on the Strategic Report, on which we are currently consulting[3] - and reporting on going concern in the financial statements. The FRC considers that companies should make an explicit link between these two disclosures; its proposals for how this might be done are set out in the following sections of this consultation document.

Section 7 also includes guidance on the statement on the review of the effectiveness of the risk management and internal control systems, as required in order to comply with the Code and covered in the 2005 guidance. The FRC is proposing a change to the current guidance in relation to significant failings or weaknesses identified during the review.

In 2005, a recommendation was added to the guidance that companies should "confirm that any necessary actions have been or are being taken to remedy any significant failings or weaknesses identified from [the] review". The intention behind this change was to encourage greater transparency about the outcomes of the review without placing companies in a position where they were asked to certify that the internal control system were effective. Many companies have simply cut and pasted the sentence from the guidance into their internal control statements. On its own, this does not indicate whether or not any significant failings or weaknesses have been identified. The FRC therefore proposes to amend the guidance to recommend more explicitly that the board should "explain what actions have been or are being taken to remedy any significant failings or weaknesses identified from that review". ***The FRC would welcome views on this proposed change to the guidance***.

Appendix A of the guidance summarises the relevant sections of the Code and other regulatory requirements of which directors should be aware, and updates the material in the introduction to the current guidance. Appendices B and C provide further guidance on how to assess and report on the company's solvency and liquidity risks and their impact on determining whether the going concern basis for preparing the financial statements is appropriate and whether there are any material uncertainties thereto; these relate to Lord Sharman's recommendations and are accordingly discussed in more detail in the next section of this document, which sets out the questions for consultation.

Appendices D and E contain questions which boards may wish to consider in applying the guidance, and indicators that may assist them in assessing how they are carrying out their responsibilities, the culture of the company, and the effectiveness of the risk management and internal control system. Appendix D is an updated version of the appendix to the existing guidance, while Appendix E is new. ***The FRC would welcome views on whether these appendices are of use to directors and, if so, how they might be improved***.

[3]The consultation document can be found at: http://frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/Exposure-Draft-Guidance-on-the-Strategic-Report-File.pdf

SECTION 3: Implementing the recommendations of the Sharman Panel on going concern

The FRC has published, concurrently with this consultation, a Feedback Statement relating to the January 2013 Consultation Paper, 'Implementing the recommendations of the Sharman Panel - Revised Guidance on Going Concern and revised International Standards on Auditing (UK and Ireland)' (the "January Consultation"). The Feedback Statement summarises the responses received from stakeholders to the proposals for implementing the Sharman recommendations set out in the January Consultation. There was general support for the recommendations of the panel but significant concerns were raised about the proposed approach to implementing them. The FRC is taking the following revised approach for Code companies.

Limiting the use of the term 'going concern' to its accounting standards meaning

The term 'going concern' was used with two separate meanings in the January Consultation relating to the objectives of narrative reporting about solvency and liquidity risks and the financial reporting about the going concern basis of accounting and material uncertainties thereto (the 'going concern information'). Stakeholders found this confusing causing the two separate objectives to be conflated. The term 'going concern' has a very particular meaning in the accounting (and auditing) standards and is widely used internationally in that context. The FRC has concluded that it would not be realistic to change that use and that to avoid confusion the term should therefore only be used in that context.

Accordingly, the term 'going concern' is only used in the revised guidance as defined in the accounting standards and the term 'going concern assessment' suggested in the January Consultation has been replaced with the term 'assessment of solvency and liquidity risks'.

Separating narrative reporting of solvency and liquidity risks from a positive going concern assertion

Stakeholders felt that linking narrative disclosures (about solvency and liquidity risks that would threaten severe distress if they were to materialise) to the going concern statement currently required under Code provision C.1.3 and the Listing Rules (that the company 'is a going concern') would be confusing and/or misleading. The Sharman Panel had envisaged in making its recommendations that there would always be disclosures about such solvency and liquidity risks, conveying information about future uncertainty and how it was being addressed. Making an assertion that the company is a "going concern" throughout the time period during which those risks might exist would set a very high threshold that most companies would fail to meet and so many companies would potentially modify the assertions, damaging confidence in business.

The FRC acknowledges these concerns and considers that linking the narrative disclosures to the going concern statement or any binary assertion about the future prospects of the company would suffer from the same unintended consequences. The FRC concluded that an assertion-based approach to triggering narrative disclosures is not necessary to achieve the intended enhanced narrative disclosures and that it should be therefore be removed.

Instead, the FRC proposes to achieve enhanced narrative disclosure by a new Code provision in Section C.2 of the Code (as further explained in Section 4 below) for the directors to establish and carry out a robust assessment process for identifying the principal solvency and liquidity risks the company faces and to affirm that they have done so. Appendix B to the revised guidance describes a robust assessment process for a company applying the Code, and what would constitute a principal solvency or liquidity risk:

> “The principal solvency and liquidity risks are those risks or combinations of risks that (in the judgement of the board) could so seriously damage the company’s cash flows, performance or future prospects that they would give rise to severe distress if they materialised.”

In addition, the FRC proposes to amend the Code to remove the current requirement in Section C.1.3 for a going concern statement in addition to what is required under accounting standards. This is explained in more detail in Section 4 of this document.

Addressing concerns about a ‘high level of confidence’ over the ‘foreseeable future’

The January Consultation suggested that a company should be “judged to be a going concern if, for the foreseeable future, there is a high level of confidence that it will have the necessary liquid resources to meet its liabilities as they fall due and will be able to sustain its business model, strategy and operations and remain solvent …”. The terms ‘high level of confidence’ and ‘foreseeable future’ were read by respondents as implying an unintended expectation that there should be no limit to the period or extent of the assessment.

The Sharman Panel did not want to change the time period of the typical <u>quantitative</u> focus of the assessment as it has been traditionally applied in determining the going concern information. In the UK and Ireland, the generally accepted minimum period of assessment is twelve months from the date of approval of the financial statements, which is driven by the accounting and auditing standards. However, this does not mean a fixed period of twelve months. The accounting standards require all information that is available about the future to be taken into account.

Appendix B of the draft revised guidance requires consideration of solvency and liquidity over longer periods having regard to the evolution of the company’s own business cycles and the economic cycle. Any information obtained in considering solvency and liquidity over longer periods would also have to be taken into account by the directors in making their determination of the going concern information, if relevant. Hence the guidance takes the approach that there is a single assessment process that informs each of the different reporting requirements.

The ‘high level of confidence’ threshold and the ‘foreseeable future’ terms have not therefore been taken forward in the Appendix B of the draft revised guidance. The high level of confidence concept has been retained only in the narrower and more appropriate context of the going concern basis of accounting (as discussed below). ***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?***

Guidance on determining material uncertainties to the going concern basis of accounting

Concerns were raised about the FRC giving guidance on the application of IFRS in relation to material uncertainties to the going concern basis of accounting. There were also concerns that the guidance on what would be material should be more focused on judgement than prescriptive thresholds. 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. This is given in Appendix C of the draft revised guidance. The FRC believes that this guidance as modified is appropriate and consistent both with IFRS and UK and Ireland accounting standards.

In responding to the comments received, the overriding requirement for judgement, which received strong support, has also been given greater emphasis and the more prescriptive thresholds removed. As flagged above, the term ‘a high level of confidence’ appears only in the statement that when severe distress has occurred or the directors judge that it will occur during the twelve months from approval of the financial statements “the board needs to have *a high level of confidence* that solvency and liquidity risk can be managed effectively” during that period. It is intended to indicate that there is likely to be a material uncertainty unless the directors are able to judge with a high level of confidence that they would have realistic options available to them for managing the identified risks in those circumstances. ***Do you agree with the guidance in Appendix C of the draft revised guidance? If not, how should it be amended and why?***

The FRC will also continue to seek to influence the IASB to develop greater clarity in relation to the requirements for the determination of when going concern material uncertainties exist and what should be disclosed about them under IFRS. Appendix C of the draft revised guidance will be kept under review for consistency with any such developments.

Related documents

Guidance to directors of banks

Respondents to the January Consultation expressed strong support that, particularly in the context of the going concern assessment and related disclosure, it was appropriate to issue separate guidance to deal with issues particular to banks. Some called for greater consistency with certain aspects of the generic guidance.

The FRC therefore proposes to issue the ‘Supplement for Banks’ included in the January Consultation as a standalone document ‘Guidance for the Directors of Banks: Solvency and Liquidity Risks and the Going Concern Basis of Accounting’, making such changes as are necessary to keep it consistent with the final wording of the Code and the draft revised guidance. The resulting proposed amendments are shown in the draft now being published for comment concurrently with this consultation. ***Do you agree with the revised guidance? If not, what needs to be amended and why?***

Auditing standards

Respondents to the January Consultation expressed a strong preference for revisions to auditing standards to be made through influencing changes to the IAASB’s international standards on auditing. The FRC has already changed auditing standards in the UK and Ireland following its effective company stewardship consultation in 2012 to require auditors to consider and report on narrative disclosures, including risks.

The proposed changes to auditing standards in the January Consultation were to encompass consideration of the principal solvency and liquidity risks and reporting thereon into that approach. Accordingly, the FRC proposes to implement the changes to the auditing standards proposed in the January Consultation, updated to reflect the other changes to the implementation approach. The requirement proposed in the January Consultation for the auditor to report if they have anything to add to what the directors’ have included in the annual report and accounts in relation to solvency and liquidity risks and going concern, has been amended to require the auditor to report if they have anything material to add. Draft revised auditing standards are also being published concurrently with this consultation. ***Do you agree with the draft revised auditing standards? If not, what should be changed and why?***

The FRC continues to work closely with the IAASB to ensure that the IAASB auditor reporting proposals will be able to accommodate the approach to governance in the Code and the FRC's desire to address audit committee and auditor reporting issues in a holistic manner.

SECTION 4: Associated changes to the UK Corporate Governance Code

The FRC would also welcome views on whether – assuming that consultees agree with the approach set out in the previous sections – changes should be made to the UK Corporate Governance Code to facilitate the integration of the assessment of, and reporting on, the going concern basis of accounting and material uncertainties thereto, with the broader assessment of, and reporting on, its principal risks. Any changes resulting from this consultation would be incorporated in a revised edition of the Code that would apply to reporting periods beginning on or after 1 October 2014.

The Code principle on risk management and internal control (Principle C.2) was revised in 2010. It was broadened so that, as well as addressing the board's responsibility for oversight of the internal control system, it set out its responsibility for "determining the nature and extent of the principal risks it is willing to take in achieving its strategic objective" (wording already used in 'Internal Control: Guidance for Directors').

However, no changes were made to the related 'comply or explain' provision of the Code (Provision C.2.1) at that time.

The FRC would welcome views on whether a new provision should be added to Section C.2 of the Code that would serve three purposes:

- to reflect the board's broader responsibilities for risk management and internal control as set out in the Code provision and the draft revised guidance;
- to encourage boards to discuss how the principal risks are managed or mitigated. This is not explicitly required under the Companies Act, but many companies already provide this information and the draft FRC guidance on the Strategic Report (on which the FRC is currently consulting[3]) recommends that they do so; and
- to establish a clear link between the disclosures the company makes on its principal risks in the Strategic Report and those it makes on its going concern status in the financial statements, while clarifying the distinction between the two.

The proposed wording of the new provision is:

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

The FRC considers that, if a new provision along these lines were to be added to the Code, it would be logical to delete existing Provision C.1.3, which states that "the directors should report in annual and half yearly financial statements that the business is a going concern, with supporting assumptions or qualifications as necessary". This should help to eliminate any confusion about the potential dual use of the term 'going concern' raised by respondents to the January Consultation.

The FRC considers that, as regards the annual report and accounts, the existing provision would be superseded by a combination of the broader disclosure of material uncertainties required under proposed new provision C.2.1 and the existing requirements in accounting standards. In addition, the FCA's Disclosure and Transparency Rules require listed companies to disclose in their half-yearly financial reports any changes in accounting policies and/or in their principal risks since the previous annual report and accounts.

The FRC recognises that the FCA's Listing Rules also include a requirement for the annual report and accounts to contain "a statement made by the directors that the business is a going concern, together with supporting assumptions or qualifications as necessary", that must be prepared in accordance with the FRC guidance. If, as a result of this consultation, the FRC proposes to amend the Code, it will discuss with the FCA a possible change to the Listing Rules.

The FRC is also seeking views on two other possible changes to the Code, both unrelated to the proposed revisions to the guidance.

The first is to refer to "principal risks" rather than "significant risks" in Principle C.2 and the proposed new Provision C.2.1, in order to be consistent with the wording in the Companies Act.

The second is to reword the existing Code provision to distinguish between the board's on-going monitoring of the risk and internal control system and the formal annual review of the system's effectiveness on which the Code requires them to report. While the existing guidance makes it clear that "effective monitoring on a continuous basis is an essential component of a sound system of internal control", is has been suggested that the current wording of the Code can be interpreted as meaning that only a one-off review is required. The FRC proposes to clarify that this is not the case, and considers that companies that already apply the guidance will not face any additional burdens as result.

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.

Proposed revisions to the UK Corporate Governance Code

Note: *proposed additions are shown in* **<u>bold and underlined</u>** *text; proposed deletions are shown in* ~~strike through~~ *text.*

C.1: Financial and Business Reporting

Main Principle

The board should present a fair, balanced and understandable assessment of the company's position and prospects.

Supporting Principle

The board's responsibility to present a fair, balanced and understandable assessment extends to interim and other price-sensitive public reports and reports to regulators as well as to information required to be presented by statutory requirements.

The board should establish arrangements that will enable it to ensure that the information presented is fair, balanced and understandable.

Code Provisions

C.1.1. The directors should explain in the annual report their responsibility for preparing the annual report and accounts, and state that they consider the annual report and accounts, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the company's performance, business model and strategy. There should be a statement by the auditor about their reporting responsibilities.

C.1.2. The directors should include in the annual report an explanation of the basis on which the company generates or preserves value over the longer term (the business model) and the strategy for delivering the objectives of the company.

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

C.2: Risk Management and Internal Control

Main Principle

The board is responsible for determining the nature and extent of the ~~significant~~ **<u>principal</u>** risks it is willing to take in achieving its strategic objectives. The board should maintain sound risk management and internal control systems.

Code Provision

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

C.2.**<u>2</u>** ~~1.~~ ~~The board should, at least annually, conduct a review of the effectiveness of the company's risk management and internal control systems and should report to shareholders that they have done so.~~ **<u>The board should monitor the company's risk management and internal control and, at least annually, carry out a review of their effectiveness, and report to shareholders that they have done so.</u>** The **<u>monitoring and</u>** review should cover all material controls, including financial, operational and compliance controls.

Financial Reporting Council

November 2013

Appendix to Consultation Paper

Draft Guidance to Directors on Risk Management, Internal Control and the Going Concern Basis of Accounting

Contents

SECTION 1: Introduction

1. The UK Corporate Governance Code ("the Code") defines the role of the board as being "to provide entrepreneurial leadership of the company within a framework of prudent and effective controls which enables risk to be assessed and managed". An understanding of the risks facing the company is essential for the development and delivery of its strategic objectives, its ability to seize new opportunities, and to ensure its longer term survival. It is one of the most important issues with which boards must concern themselves.

2. Good stewardship by the board should not inhibit sensible risk taking that is critical to the growth and maintenance of economic activity. However the assessment and reporting of risks as part of the normal business planning process should support better decision-taking, ensure that the board and management respond promptly to risks when they arise, and that shareholders and other stakeholders are well informed about the principal risks.

3. Economic developments and some high profile failures of risk management in recent years have reminded boards of the need to ensure that the company's approach to risk has been properly considered in setting the strategy and that the company is monitoring and managing its risks, and of the financial and reputational consequences if they do not do so effectively. The renewed focus on risk has been reflected in the more insightful reporting on risk and internal control now being provided by many companies.

4. The Code was updated in 2010 to make it clear that, in addition to being responsible for ensuring a sound risk management and internal control system, boards should determine the nature and extent of the principal risks they were willing to take to achieve the company's strategic objectives.

5. In 2011 the FRC published the 'Boards and Risk' report, which reflected the views of directors, investors and risk experts. In 2012 the Sharman Inquiry into going concern and liquidity risks concluded that the assessment of whether the company remained a going concern should be more broadly based than is required to determine the accounting approach to be taken. The high level conclusions of the two reports were consistent and, if combined, can be summarised as:

   - The board must determine its willingness to take on risk, and the desired risk culture within the company;

   - Risk management and internal control should be incorporated within the company's normal management and governance processes, not treated as a separate compliance exercise;

   - The board must make a robust assessment of the principal risks to the company's business model and ability to deliver its strategy, including solvency and liquidity risks. In making that assessment the board should consider the likelihood and impact of these risks materialising in the short and longer term;

   - Once those risks have been identified, the board should agree how they will be managed and mitigated, and keep the company's risk profile under review. It should satisfy itself that management's systems include appropriate controls, and that it has adequate sources of assurance;

- The assessment and management of the principal risks, and monitoring of the associated controls, should be carried out on an on-going process, not seen as an annual one-off exercise; and

- This process should inform a number of different disclosures in the annual report: the description of the principal risks and uncertainties facing the company in the strategic report; the disclosures in the financial statements on the going concern basis of accounting and material uncertainties thereto; and the report on the review of the risk management and internal control system.

6. In order to encourage boards to consider risk identification and management and the assessment of whether the company is able to adopt the going concern basis of accounting as being part of the same on-going process, the FRC has decided to bring together its guidance on these matters in one place. This guidance replaces 'Internal Control: Guidance for Directors' (2005) and 'Going Concern and Liquidity Risk: Guidance for Directors' (2009). It aims to link the traditional "internal control" guidance with emerging good practice for risk management and the recommendations from the Sharman Inquiry which touch on the same issues.

7. While we hope this guidance will be useful to all organisations, it is primarily addressed to companies subject to the UK Corporate Governance Code (i.e. companies with a Premium Listing of equity shares in the UK, irrespective of whether or not they are incorporated in the UK). The FRC issues separate guidance on solvency and liquidity risks and the going concern basis of accounting for other companies.

8. This guidance uses the term "going concern" specifically to refer to the basis of preparation of the financial statements as defined in accounting standards, which is different from the ordinary English usage of the term "going concern". The usage of the term in accounting standards is well-established.

9. The FRC has developed the guidance on the basis that boards should make clear in their reporting of principal risks which of them are a potential threat to solvency or liquidity (which we consider to be a more common interpretation of the term "going concern" risks) and how they are being dealt with. We have suggested that the going concern assertion for financial statement purposes be made as part of the financial statements, but that any material uncertainties to the going concern basis of accounting are also likely to form part of, and be informed by, the principal risk disclosures that listed companies are required to include in the Strategic Report.

10. The guidance does not set out in detail the framework by which the company's principal risks are managed or mitigated or through which the board receives assurance. It is for each board to ensure that its framework is robust and effective.

11. Attempting to define a single approach to achieving best practice would be misguided if it led boards to underestimate the crucial importance of the culture and behaviour they promote to high quality risk management. As well as the systems and processes addressed in this guidance, the board and management need to pay attention to a wide range of factors, including incentives, training, values and the leadership and management style of the company.

12. The approach taken in the guidance is to:

- prompt boards to consider how to discharge their responsibilities in relation to the principal existing and emerging risks faced by the company and the continually evolving business environment;

- reflect sound business practice whereby risk management and internal control are embedded in the business processes by which a company pursues its objectives; and

- enable each company to apply the guidance in a manner which takes account of its particular circumstances.

13. Sections 2 and 3 of the guidance summarise the board's responsibilities for risk management and identify some of the factors that boards should consider in order to exercise those responsibilities effectively. Section 4 addresses how risks are assessed. Sections 5 and 6 address the design and process for reviewing the risk management and internal control system, while Section 7 concerns the information boards are expected to disclose in the annual report.

14. Sections 5 to 7 comprise the core of the previous 'Internal Control: Guidance for Directors', although Section 7 now addresses reporting on principal risks and going concern as well as the internal control statement. Section 2 to 4 are new, and are intended to align the scope of the guidance with the Code principle on risk management and internal control by addressing the full range of the board's responsibilities.

15. Appendix A of the guidance summarises the relevant sections of the Code and other regulatory requirements of which directors should be aware. Some companies may be subject to other relevant regulatory requirements, for example because they operate within a regulated sector or because they are registered or listed in more than one jurisdiction. Companies will need to bear any such requirements in mind when considering how to apply this guidance.

16. Appendices B and C provide further guidance on how to assess and report on the company's solvency and liquidity risks and their impact on the going concern basis for preparing the financial statement and any material uncertainties thereto. In addition, the FRC has issued a separate guidance for directors of banks on going concern, which addresses considerations specific to the banking sector, and which should be read in conjunction with this Guidance

17. Appendices D and E contain questions which boards may wish to consider in applying the guidance, and indicators that may assist them in assessing how they are carrying out their responsibilities, the culture of the company, and the effectiveness of the risk management and internal control system.

18. Throughout this guidance, where reference is made to 'company' it should be taken, where applicable, as referring to the group of which the reporting company is the parent company. For groups of companies, the review of the effectiveness of the risk management and internal control systems and all reporting to the shareholders should be from the perspective of the group as a whole.

SECTION 2: Responsibilities

19.The board's specific responsibilities in relation to risk include:

- determining the extent to which the company is willing to take on risk (its "risk appetite"),
- ensuring that an appropriate risk culture has been instilled throughout the organisation;
- identifying and evaluating the principal risks to the company's business model and the achievement of its strategic objectives, including risks that could threaten its solvency or liquidity;
- agreeing how these risks should be controlled, managed or mitigated;
- ensuring there is an appropriate risk management and internal control system in place, including reward systems;
- reviewing the risk management and internal control systems and satisfying itself that they are functioning effectively and that corrective action is being taken where necessary; and
- taking responsibility for external communication on risk management and internal control.

20.The board's specific responsibility for determining the going concern basis of accounting is a sub-set of these broader responsibilities. A company that is a going concern for the purposes of the financial statements is not necessarily free of risks that might threaten the company's solvency or liquidity were they to materialise. The board is responsible for ensuring this distinction is understood internally and communicated externally.

21.It is the role of management, not the board, to implement and take day-to-day responsibility for board policies on risk and control. But the board needs to satisfy itself that management have understood the risks, implemented and monitored appropriate policies and controls, and are providing the board with timely information so that it can discharge its own responsibilities. In turn, management should ensure responsibilities are clearly established at all levels of the organisation.

22.All employees share responsibility for behaving according to the agreed risk culture. Management should ensure that employees have the necessary knowledge, skills, information, and authority to establish, operate and monitor the system of risk management and internal control.

SECTION 3: Excercising Responsibilities Effectively

23. The ability of the board to understand and address the risks facing the company is itself a major risk factor. The board needs to ensure that informed debate is possible and constructive challenge encouraged, and to keep under review the effectiveness of its decision-making processes. The principles of the UK Corporate Governance Code, which are intended to help the board and its committees operate effectively, also underpin good risk management and internal control.

24. It is for the board to decide what arrangements to put in place to enable it to exercise its responsibilities. These will depend upon factors such as the size and composition of the board; the scale, diversity and complexity of the company's operations; and the nature of the principal risks that the company faces. But in coming to its decision the board should consider, amongst other things:

- The values and behaviours that it wishes to instil in the company, and whether this has been achieved.

  As with all aspects of good governance, the effectiveness of risk management and internal control ultimately depends on the individuals responsible for operating the systems that are put in place. In order to ensure the appropriate risk culture is in place it is not sufficient for the board simply to set the desired values. It also needs to ensure they 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.

  This should include consideration of whether the company’s leadership and management style and structures, human resource policies and reward systems support or undermine the risk management and internal control system.

- How to ensure there is adequate discussion at the board.

  The board should agree the frequency and scope of its discussions on strategy, capital and risk; how assessment of the principal risks that could affect the company’s performance, solvency or liquidity is integrated with other matters considered by the board; and how to assess the impact on the company’s risk profile of decisions on changes in strategy, major new projects and other significant commitments. The board should consider whether there is a need for specific discussion on strategy, capital and risk in addition to that which takes place in normal board meetings.

- The skills and experience of the board and management.

  The board should consider whether it, and any committee to which activities are delegated, has the necessary skills, knowledge, experience and support to enable it to understand and assess the principal risks and opportunities the company faces and exercise its responsibilities effectively. Boards should consider specifically assessing this as part of their regular evaluations of their effectiveness. Similar assessments should be made when the board reviews the capabilities and performance of senior management.

- The flow of information to and from the board, and the quality of that information.

  The board should specify the nature, source, format and frequency of the information that it requires on existing and emerging risks. It should ensure that the assumptions underlying this information are clear so that they can be understood and if necessary challenged. The board should understand the extent to which models have been used and their limitations, including key assumptions. It should also ensure that there are clear processes for bringing significant issues to the board's attention more rapidly when required, and agreed triggers for doing so.

- The use, if any, made of board committees.

  The board should determine to what extent it wishes to obtain advice from, or delegate responsibilities to, the risk committee (if there is one), the audit committee or other committees. To the extent that it does so, it should be satisfied that the arrangements for the work carried out by those committees, for the co-ordination of their work (if more than one committee is involved), and for reporting to the board are appropriate and operating effectively.

  The board should also consider whether the remuneration committee takes appropriate account of risk when determining remuneration policies and awards, and whether the links between the remuneration committee and the risk and/or audit committee are operating effectively.

- What assurance the board requires, and how this is to be obtained.

  The board should identify what sources of assurance it requires and, where there are gaps, how these should be addressed. In addition to the board and its committees' own monitoring activities, sources of assurance might include reports on relevant matters from any compliance, risk management and internal audit functions within the company, the external auditor's communications to the audit committee about matters it considers relevant to the board and the audit committee in fulfilling their responsibilities, and other internal and external sources of information or assurance.

  The board should satisfy itself that these sources of assurance have sufficient integrity, independence and expertise to enable them to provide objective advice and information to the board.

SECTION 4: Identifying and Assessing Principal Risks

25. The board should identify the principal risks facing the company and evaluate the likelihood of their incidence, and their impact if they were to materialise. It should assess the availability and likely effectiveness of actions that it would consider undertaking, either in advance or when a trigger event occurs, to avoid or reduce the impact of the underlying risks.

26. The board needs to be aware of those risks or combination of risks that can seriously affect the future performance, solvency or liquidity of the company, irrespective of how they are classified or whether they stem from failures of strategy, operations, organisation or behaviour, or from external factors over which the board may have little or no direct control. The board should treat such risks as principal risks and establish clearly the extent to which they are to be avoided, transferred, mitigated or tolerated.

27. The design of the assessment process should be appropriate to the complexity, size and circumstances of the company and is a matter for the judgement of the board, with the support of management. Circumstances may vary over time with changes in the business model, performance, strategy and operational processes and with the stage of development the company has reached in its own business cycles. There may also be changes in the external environment.

28. The board should consider undertaking stress tests and reverse stress tests to review different scenarios; assess the economic, financial or other conditions in which potentially significant risks may materialise; and identify what actions might be taken to mitigate against such outcomes. Appendix B provides further guidance on stress testing.

29. In evaluating the impact of principal risks materialising, the board should consider the sufficiency of the company's risk management processes and internal controls and contingency plans, and be clear about the extent to which there are residual risks even where these are operating effectively.

30. The board should specifically consider the principal solvency and liquidity risks and other risks that would so seriously affect the company's cash flows, performance or future prospects that they would give rise to severe distress if they were to materialise. Solvency is the company's ability to meet its liabilities, and requires sufficient capital and a business model capable of generating an economic return; liquidity is the company's ability to liquidate its assets or generate funding at the pace needed to meet its liabilities. Appendix B provides further guidance on assessing solvency and liquidity risks and Appendix C discusses the nature of severe distress and possible indicators of it.

SECTION 5: Establishing the Risk Management and Internal Control System

31.The risk management and internal control system encompasses the policies, culture, processes, systems and other aspects of a company that, taken together:

- facilitate its effective and efficient operation by enabling it to respond appropriately to principal risks and significant control failures, to identify emerging risks and to safeguard its assets;
- reduce the likelihood of poor judgement in decision-making; risk-taking that exceeds the levels agreed by the board; human error; control processes being deliberately circumvented by employees or others; or management overriding controls;
- help ensure the quality of internal and external reporting. This requires the maintenance of proper records and processes that generate a flow of timely, relevant and reliable information from within and outside the organisation; and
- help ensure compliance with applicable laws and regulations, and also with internal policies with respect to the conduct of business.

32.A company's system of risk management and internal control will include: control activities; information and communications processes; and processes for monitoring its continuing effectiveness.

33.The risk management and internal control system should be embedded in the operations of the company; be capable of responding quickly to evolving risks and opportunities to the business arising from factors within the company and to changes in the business environment; and include procedures for reporting immediately to appropriate levels of management and to the board any significant increases in the company's risk exposure or significant control failings or weaknesses that are identified together with details of corrective action being undertaken.

34.When developing a system of risk management and internal control that is suited to the particular circumstances of the company, the board should consider:

- the nature and extent of the risks facing, or being taken by, the company which it regards as desirable or acceptable for the company to bear. For example, the higher the risks accepted, the greater the likely need for stronger and more timely monitoring controls and contingency planning; while an exposure to low probability but high impact risks may increase the need for effective crisis management systems;
- the exposure to risks before and after the application of controls and mitigations, as appropriate;
- the likelihood of the risks concerned materialising, and the consequence of related risks materialising as a result or at the same time;
- the company's ability to reduce the incidence and impact on the business of risks that do materialise, and to withstand such instances;
- the effectiveness and relative costs and benefits of particular controls; and

- the impact of the values and culture of the company, and the way that teams and individuals are incentivised, on the effectiveness of the system.

35. Effective financial controls are an important element of the system of risk management and internal control. They help ensure that the company is not unnecessarily exposed to risks that should be avoided or mitigated and that financial information used within the business and for publication is reliable. They also contribute to the safeguarding of assets, including the prevention and detection of fraud.

SECTION 6: Reviewing the Risk Management and Internal Control System

36. Effective monitoring on a continuous basis is an essential component of a sound system of risk management and internal control. The board should form its own view on effectiveness based on the evidence it obtains, exercising the standard of care generally applicable to directors in the exercise of their duties. The board should define the processes to be adopted for its on-going scrutiny. This should encompass both the scope and frequency of the reports it receives and reviews during the year.

37. The regular reports to the board from management and other sources of information and assurance should between them provide a balanced assessment of the principal risks and the effectiveness of the system of risk management and internal control in managing those risks. Any significant control failings or weaknesses identified should be discussed in the reports, including the underlying reasons, the impact that they have had, or may have, on the company and the actions being taken to rectify them.

38. When reviewing reports during the year, the board should consider: how effectively the principal risks have been identified and evaluated; how they have been mitigated and managed; whether necessary actions are being taken promptly to remedy any significant failings or weaknesses; and whether the causes of the failing or weakness indicate poor decision-taking or a need for more extensive monitoring or a reassessment of the effectiveness of management's on-going processes.

39. In addition to its on-going scrutiny, the board should undertake an annual assessment to ensure that it has considered all significant aspects of risk management and internal control for the company for the year under review and up to the date of approval of the annual report and accounts. The board should define the processes to be adopted for this assessment, including drawing on the results of the board's on-going scrutiny such that it will obtain sound, appropriately documented, evidence to support its statement in the company's annual report and accounts.

40. The annual assessment should, in particular, consider:

- the company's willingness to take on risk (its risk appetite);
- the culture of the company and the extent to which the desired culture has been instilled;
- the integration of risk management with considerations of strategy and capital, and with business planning processes;
- the changes in the nature and extent of principal risks, and the company's ability to respond to changes in its business and the external environment;
- the scope and quality of management's on-going monitoring of risks and of the system of risk management and internal control, and, where applicable, the work of its internal audit function and other sources of assurance;
- the extent, frequency and quality of the communication of the results of the monitoring to the board (or board committees) which enables it to build up a cumulative assessment of the state of control in the company and the effectiveness with which risk is being managed;

- issues dealt with in reports reviewed by the board during the year, in particular the incidence of significant control failings or weaknesses that have been identified at any time during the period and the extent to which they have resulted in unforeseen outcomes or contingencies that have had, could have had, or may in the future have, a material impact on the company's performance or reputation; and

- the effectiveness of the company's public reporting processes.

SECTION 7: Communication

41.The assessment and processes set out in this guidance should be used to inform a number of distinct but related disclosures in the annual report and accounts. These are:

- reporting on the principal risks and uncertainties facing the company (as required by the Companies Act and the Code);

- reporting on the preparation of the company's financial statements on the going concern basis of accounting and material uncertainties thereto (as required by accounting standards)*;* and

- reporting on the review of the risk management and internal control system (as required by the Code), and the main features of the company's risk management and internal control system in relation to the financial reporting process (as required under the Disclosure and Transparency Rules) .

42.The purpose of such reporting is to provide information about the company's business model, strategy and financial position. It helps to demonstrate the board's stewardship and governance, and encourages shareholders to perform their own stewardship role by engaging in appropriate dialogue with the board and holding the directors to account as necessary.

43.As with all parts of the annual report and accounts, the board should provide succinct, meaningful, information that is tailored to the specific circumstances of the company, and should avoid using standardised language which may be long on detail but short on insight. The board should ensure that the different disclosures summarised below are fair, balanced and understandable in themselves and in relation to the annual report and accounts as a whole,

44.For groups of companies, all reporting should be from the perspective of the group as a whole. Where material joint ventures and associates have not been dealt with as part of the group, this should be disclosed and an explanation given of how the board assesses and manages the risks if it does not have line of sight.

Principal risks and uncertainties

45.**UK company law requires boards to describe the principal risks and uncertainties facing the business in its Strategic Report. The UK Corporate Governance Code states that, when disclosing these risks, the board should confirm that it has carried out a robust assessment of the principal risks facing the company, including those that would threaten the solvency and liquidity of the company; explain how they are being managed or mitigated; and indicate which, if any, are material uncertainties in relation to the company's ability to continue to adopt the going concern basis of accounting.**

46.When reporting on the company's principal risks and uncertainties, the board should focus on those risks it considers to be the most important to the future development, performance or position of the company. This should include, but not be limited to, significant risks to its solvency or liquidity.

47.The descriptions of the principal risks and uncertainties should be sufficiently specific that a shareholder can understand why they are important to the company. The report might include a description of the likelihood of the risk, an indication of when the risk might be most relevant to the entity and its possible effects. Significant changes in principal risks such as a change in the likelihood or possible effect, or the inclusion of new risks, should be highlighted and explained. A high-level explanation of how the principal risks and uncertainties are being managed or mitigated should also be included.

48. A risk or uncertainty may be unique to the entity, a matter that is relevant to the market in which it operates or something that applies to the business environment more generally. Where the risk or uncertainty is more generic, the description should make clear how it might affect the entity specifically.

49. The report should indicate explicitly which, if any, of the principal risks and uncertainties identified in the strategic report are also material uncertainties for the purposes of reporting in the financial statements on the company's ability to continue as a going concern.

Going concern

50. **Accounting standards require companies to determine whether the going concern basis of accounting should be adopted and, if so, to identify in the annual financial statements any material uncertainties related to events or conditions that may cast significant doubt upon its ability to continue as a going concern. Companies listed in the UK are also required under the Disclosure and Transparency Rules to report any changes to their accounting policies, which would include preparation on a going concern basis, in their half-yearly financial reports.**

51. Accounting standards state that the decision on whether to prepare its financial statements on a going concern basis should be determined by whether management "intends to liquidate the entity or to cease trading or has no realistic alternative but to do so". The board must either confirm in the financial statements that the going concern basis has been adopted or, if it has not, include an explanation and a description of the alternative basis that has been adopted.

52. Any necessary disclosures about material uncertainties identified by the board should be linked to, and consistent with, reporting on principal risks and uncertainties in the Strategic Report.

53. Further guidance on the going concern basis of accounting and disclosures on material uncertainties to be included in the financial statements is provided in Appendix C.

Statement on risk management and internal control

54. **In order to comply with Provision C.2.2 of the UK Corporate Governance Code, the board should report on its review of the effectiveness of the company's risk management and internal control systems.**

55. The report on the review of the risk management and internal control systems is normally included in the corporate governance section of the annual report and accounts, but this reflects common practice rather than any mandatory requirement and companies can choose where to position their report.

56. In any event, companies should consider whether and how to link reporting on the review of the risk management and internal control systems to the information on principal risks and uncertainties in the Strategic Report, and material uncertainties relating to the going concern basis of accounting in the financial statements.

57. In its statement the board should, as a minimum: acknowledge that it is responsible for that system and for reviewing its effectiveness; and disclose that there is an on-going process for identifying, evaluating and managing the principal risks faced by the company, that it has been in place for the year under review and up to the date of approval of the annual report and accounts, that it is regularly reviewed by the board, and to what extent it accords with the guidance in this document.

58. The board should summarise the process it has applied in reviewing the effectiveness of the system of risk management and internal control. The board should explain what actions have been or are being taken to remedy any significant failings or weaknesses identified from that review, including the process it has applied to deal with material risk management or internal control aspects of any significant problems disclosed in the annual report and accounts.

59. The statement should include, or be linked to, a description of the main features of the company's risk management and internal control system in relation to the financial reporting process, as required under the Disclosure and Transparency Rules.

APPENDIX A

THE UK CORPORATE GOVERNANCE CODE AND REGULATORY REQUIREMENTS

UK Corporate Governance Code

[This section will need to be updated when the final Code wording has been decided]

Under the UK Listing Authority's Listing Rules all companies with a Premium listing of equity shares in the UK, irrespective of their country of incorporation, are required to include in the annual report and accounts a statement of how they have applied the Main Principles of the UK Corporate Governance Code and whether they have complied with its provisions. Where they have not complied with a provision, they are required to explain the reason.

Principle C.2 of the UK Corporate Governance Code 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. The board should maintain sound risk management and internal control systems".

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

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

Provision C.3.2 states that it is the responsibility of the audit committee "to review the company's internal financial controls and, unless expressly addressed by a separate board risk committee composed of independent directors, or by the board itself, to review the company's internal control and risk management systems". Further guidance on the audit committee's responsibilities is set out in the FRC's 'Guidance on Audit Committees'.

Other Code provisions are also relevant to the board's consideration of, and reporting on, risk. For example, provision C.1.1 states that the board must make a statement that "the annual report and accounts, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the company's performance, business model and strategy". Provision C.1.2 states that "the directors should include in the annual report an explanation of the basis on which the company generates or preserves value over the longer term (the business model) and the strategy for delivering the objectives of the company".

Companies Act 2006

Section 414A of the Companies Act 2006 requires all UK incorporated companies that are not small to prepare a strategic report for each financial year of the company. This report must include, amongst other things, "a fair review of the company's business, and a description of the principal risks and uncertainties facing the company". The review should be a balanced and comprehensive analysis of "the development and performance of the company's business during the financial year, and the position of the company's business at the end of the year".

The purpose of the strategic report is to help "members of the company" (shareholders) assess how the board has performed its duty under Section 172 of the Act, which requires that "a director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole".

Disclosure and Transparency Rules

Section 7.2.5R of the UK Listing Authority's Disclosure and Transparency Rules states that companies whose securities are admitted to trading on a regulated market (which includes all companies with Premium or Standard listings in the UK) are required to include in the corporate governance statement contained in their annual report and accounts "a description of the main features of the company's internal control and risk management systems in relation to the financial reporting process".

Separately, the Disclosure and Transparency Rules also require companies to include in their half-yearly financial reports a description of the principal risks and uncertainties for the remaining six months of the year (DTR 4.2.7) and, where accounting policies are to be changed in the subsequent annual financial statements, to follow the new policies and disclose the changes and the reasons for the changes (DTR 4.2.6).

UK Listing Rules

Under Listing Rule LR 9.8.6R (3), the annual report for a Premium listed company must include "A statement made by the directors that the business is a going concern, together with supporting assumptions or qualifications as necessary, that has been prepared in accordance with 'Going Concern and Liquidity Risk: Guidance for Directors of UK Companies 2009', published by the Financial Reporting Council in October 2009".

Accounting Standards

Paragraph 25 of International Accounting Standard 1 (IAS 1)[1] states that: "When preparing financial statements, management shall make an assessment of an entity's ability to continue as a going concern. An entity shall prepare financial statements on a going concern basis unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so. When management is aware, in making its assessment, of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, the entity shall disclose those uncertainties. When an entity does not prepare financial statements on a going concern basis, it shall disclose that fact, together with the basis on which it prepared the financial statements and the reason why the entity is not regarded as a going concern".

[1] The equivalent requirement under UK GAAP is in paragraphs 3.8 – 3.9 of FRS 102

Other regulatory requirements

Some companies may be subject to other relevant regulatory requirements, for example because they operate within a regulated sector or because they are registered or listed in more than one jurisdiction. Companies will need to bear any such requirements in mind when considering how to apply this guidance.

APPENDIX B

ASSESSING SOLVENCY AND LIQUIDITY RISKS

Solvency and liquidity risks

The principal solvency and liquidity risks are those risks or combinations of risks that (in the judgement of the board) could so seriously damage the company's cash flows, performance or future prospects that they would give rise to severe distress[2] if they materialised.

Solvency and liquidity are both important gauges for assessing the ability of the company to continue as a going concern, for the purposes of preparing the financial statements.

Liquidity risk relates to the ability of a company to meet its liabilities as they fall due and liquidity difficulties therefore primarily relate to cash flow problems or problems with access to financing facilities. Considerations relating to these aspects of going concern have been the primary focus of many assessments in the past, undertaken with a time horizon of at least 12 months from the date of the assessment.

Solvency risk relates to the ability of the company to meet its liabilities in full. It underpins the longer term ability of the company to obtain and maintain debt funding as well as equity capital for the business. It is influenced by many factors, including the sustainability of a company's business model. It is important to understand how the likely future success of the business will be perceived by providers of capital in assessing likely access to funding and liquidity (for example, doubts about the future success of a company's business model could result in short term funding becoming harder, or even impossible, to obtain).

An effective assessment of a company's solvency therefore considers the longer term and is based on both qualitative and quantitative factors. Qualitative factors might include, for example, where the company is in its own business cycles and how they fit with the general economic cycle.

Considering what information is available about the future

The board's evaluation of the principal solvency and liquidity risks should consider what the board knows or should reasonably be expected to know about the future. The assessment does not have regard to a specific period. Knowledge about the future is a matter of judgement not fact and reflects the expertise and experience of those making the evaluations about the likely development of events and conditions in future periods as part of the assessment process. The board should satisfy itself that it has sufficient information to make this assessment.

Given the accounting requirements (see Appendix C), the board needs to have 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, or else it is likely to have a going concern material uncertainty to disclose.

[2] The nature of severe distress and possible indicators of it are discussed in Appendix C.

When considering solvency, boards address longer periods through the general economic and specific business cycles. The length of the period considered is a matter of judgement and will depend on the nature of the company's business, its business plans and business cycles, the life cycles of its assets, the stage of the general economic cycle at the time of the assessment and the quality of the data available to make the assessment.

Determining the appropriate periods to be covered in carrying out individual aspects of the assessment process (such as the qualitative and quantitative evaluation of risks and potential mitigating actions, the development of budgets, forecasts and medium term strategy and plans, and the conduct of stress tests) is therefore a key aspect of establishing a robust assessment process. The appropriate periods for this purpose should in principle be consistent with those appropriate for effective business planning and management.

Stress testing and sensitivity analysis

Stress tests and sensitivity analysis are both simulation techniques used to gauge how changes in economic and financial circumstances would affect the company. Sensitivity analysis tends to be undertaken by flexing individual variables, or sometimes combinations of variables, in a model that projects the expected performance or financial outcome for the business. This may help in assessing both the company's financial adaptability and the significance of particular variables to the projected financial outcome.

Stress tests apply a more holistic approach by projecting the expected performance or financial outcome for a business in different scenarios. They are designed to test the resilience of the business to severe but plausible scenarios.

Boards may also find the use of reverse stress testing assists in understanding the potential impact of severe economic or financial distress or operational breakdown on solvency and liquidity. Reverse stress-testing starts from a hypothetical outcome of business failure (a failure of solvency or a failure of liquidity) and identifies scenarios in which this might occur. The purpose of undertaking such tests is to identify what could cause the business to fail and to use this information to ensure that the relevant risks are sufficiently well-understood and appropriately managed or mitigated to secure the success of the company.

Effective stress tests should engage senior management and the directors in the process and have the potential to provide them with a company-wide view of the impact of risks on the business.

This guidance does not set down a list of prescribed stress tests for directors to undertake. Rather, the board should consider the individual circumstances of its own company and tailor stress tests best suited to its business model, strategy, principal risks and current position and level of performance. Stress tests of liquidity and solvency should be undertaken with an appropriate level of prudence, weighting downside risks more heavily than upside opportunities.

APPENDIX C

DETERMINING AND REPORTING ON THE GOING CONCERN BASIS OF ACCOUNTING

Determining whether to adopt the going concern basis of accounting

Companies are required to adopt the going concern basis of accounting, except in circumstances where management intends to liquidate the entity or to cease trading, or has no realistic alternative to liquidation or cessation of operations.

The threshold for departing from the going concern basis of accounting is a very high hurdle and may not be reached even when material uncertainties about the entity's ability to continue as a going concern have been identified. For example, the board may have realistic alternatives to liquidation or cessation and a high level of confidence that these will be effective in avoiding that outcome. Nonetheless, there may be material uncertainties that should be disclosed given the assessed severity of the impact of the risks if they were not effectively managed or mitigated.

Severe distress

What constitutes severe distress is a matter of judgement. 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. Such actions would include, for example:

(a) discontinuing or materially curtailing the company's operations; or

(b) raising finance (or making changes to existing finance) outside the normal course of business or on other than normal terms or doing so from other than normal sources.

The board's consideration of whether there is severe distress should take full account of the availability and likely effectiveness of actions within the normal course of business that they would consider undertaking to avoid or reduce the impact or occurrence of the underlying risks and that realistically would be open to them in the circumstances.

Whether actions are within or outside the normal course of business should be determined by the board having regard to the implications for the board's strategic objectives, its financial adaptability and contingency plans and the likely implications for shareholders, creditors and other stakeholders.

What is or is not outside the normal course of business is a matter of judgement. Financial adaptability and contingency planning (for example, maintaining contingent borrowing facilities or making contingency plans to maintain profitability when identified risks that have been accepted arise) is a normal part of business planning to enable the entity to survive reasonably anticipated shocks. This may be contrasted with crisis management, which involves establishing effective systems to deal with severe shocks that were not or could not have been reasonably anticipated. Both effective contingency planning and effective crisis management systems may be important elements of an entity's risk management system.

The following examples may help to differentiate between taking actions within or outside the normal course of business:

	Within	***Outside***
Raising capital	*Planned issue to shareholders with pre-emption rights to fund the expansion of a profitable subsidiary*	*A heavily discounted and underwritten rescue rights issue to generate funds to repay or reduce defaulting debt*
Disposals	*Sale of a division, as part of a board's long-term strategic plan, returning a substantial element of the proceeds to shareholders*	*Emergency disposal of a profitable subsidiary or asset to fund the costs of a crisis*
Bank debt	*Renegotiation of existing facilities and changes to covenants in connection with the acquisition of a new subsidiary*	*Negotiating a standstill agreement, or renegotiating covenants to avoid breaching them, in response to a severe trading downturn*

Determining whether there are material uncertainties

The purpose of assessing whether there are material uncertainties is to forewarn of solvency or liquidity risks of such a potential magnitude and such a meaningful possibility of occurrence as to threaten the entity's ability to continue to adopt the going concern basis of accounting and which, if disclosed, would affect the economic decisions of shareholders and other users of the financial statements. This is a matter of judgement. In this respect, the board should consider each of the principal solvency and liquidity risks identified, both individually and in combination with others.

Possible implications of such risks, and the uncertainties inherent in them, that could influence the decisions that users make on the basis of the financial statements include, for example, effects on the realisable values of the company's assets or liabilities, its credit rating or the board's ability to pursue its strategy and business model. In determining whether there are material uncertainties, the board should consider:

(a) the magnitude of their potential impact on the company and the likelihood of their occurrence;

(b) the availability and likely effectiveness of actions (whether within or outside the normal course of business) that the board would consider undertaking to avoid or reduce their impact or occurrence and that realistically would be open to it in the circumstances; and

(c) the potential implications for shareholders and other users of the financial statements of the risks materializing, and of any actions that would be taken to address them.

They should usually be considered material uncertainties if:

(a) they have at the time of the board's assessment given rise to severe distress for which there is no realistic alternative but to take actions outside the normal course of business in order to address it, and the directors are not able to obtain a high level of confidence that such actions will be available to them and will be highly likely to be effective; or

(b) in the board's judgement, it they will, during the period of at least twelve months from the date of approval of the financial statements, give rise to such distress that there would be no realistic alternative but to take actions outside the normal course of business to address it.

However, they should not usually be considered material if the likelihood that the company will not be able to continue as a going concern is assessed to be remote, however significant the assessed potential impact.

Reporting on the going concern basis of accounting and material uncertainties

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

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

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

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

Disclosures in the financial statements should be consistent with those in the Strategic Report. Boards should indicate in the Strategic Report which, if any, of the principal risks and uncertainties they have described are also material uncertainties for the purposes of financial statement disclosures in accordance with accounting standards. In addition, users may reasonably expect that matters disclosed as material uncertainties in the financial statements would have been discussed in the Strategic Report in earlier annual reports as principal solvency and liquidity risks, unless they could not reasonably have been identified or assessed as principal solvency and liquidity risks at that earlier time.

Half-yearly financial statements

Where boards are required to prepare half-yearly financial statements[3], the same considerations should apply as for the annual financial statements in relation to disclosures about the going concern basis of accounting and material uncertainties. Boards should continue to undertake their assessment and monitoring of principal solvency and liquidity risks as part of their on-going governance of risk management and internal controls. Boards should therefore build on their understanding of these matters since the completion of the last annual report, update their conclusions on the basis of accounting and the existence of material uncertainties and revise their disclosures as necessary.

[3] Companies listed on a regulated market are required under the Disclosure and Transparency Rules to produce half-yearly financial reports which must include a description of any changes in accounting policies and the principal risks and uncertainties for the remaining six months of the year. Further guidance is available in the FRC's 'Statement on Half-Yearly Financial Reports'. See: http://frc.org.uk/Our-Work/Publications/ASB/Half-yearly-financial-reports-(July-2007)-File.pdf

APPENDIX D

QUESTIONS FOR THE BOARD TO CONSIDER

Some questions which the board may wish to consider and discuss with management and others such as the risk management or internal audit functions are set out below. The questions are not intended to be exhaustive and should be tailored to the particular circumstances of the company.

This Appendix should be read in conjunction with the guidance set out in this document.

Risk appetite and culture

- What risks is the board willing to take, and what risks will it not take?
- Has the board and management reviewed the ability of the company to manage the risks that it faces? How effectively is the company able to withstand risks which do materialise?
- Do the board and its committees have the skills, knowledge, experience and support necessary to understand the risks facing the company?
- How does the board ensure that it has sufficient time to consider risk, and how is that integrated with discussion on other matters for which the board is responsible?
- Do the company's culture, code of conduct, human resource policies and performance reward systems support the business objectives and risk management and internal control system?
- How has the board assessed whether senior management promotes the desired culture and demonstrates the necessary commitment to risk management and internal control?
- How does the company communicate to its employees what risks are or are not acceptable, what is expected of them and the scope of their freedom to act? How does the board assess whether this has been understood and acted on by employees?
- How have the board and management assessed whether employees have the knowledge, skills and tools to support the achievement of the company's objectives and to manage risks effectively?
- What are the channels of communication that enable individuals to report suspected breaches of law or regulations or other improprieties? How do the board and management respond to those raising genuine concerns?
- How is inappropriate behaviour dealt with?

Risk assessment

- What is the company's business model and strategy, and what are the inherent risks? What are the activities or factors on which successful delivery of the strategy depends, and are they being managed appropriately?
- How, and how often, are the company's principal internal and external risks assessed?

- How effectively does the company capture new and emerging risks and opportunities? What triggers the decision to notify the board that a significant risk has materialised?

- How does the board assess risk when considering changes in strategy or approving new transactions, projects, products or other major commitments?

- What are the strategies for dealing with the significant risks that have been identified? Has the company considered scenarios in which risks might become realities?

- Does the board understand the company's exposure to each principal risk before and after the application of mitigations and controls, what those mitigations and controls are and whether they are operating as expected?

- How has the board assessed the interrelationship between different risks and the impact of them materialising at the same time?

- What risks is the company exposed to through joint ventures, outsourced activities and its supply chain? How are these managed?

<u>The risk management and internal control system</u>

- Are authority, responsibility and accountability for risk management and internal control clearly defined and appropriately co-ordinated?

- What are the processes by which senior management monitor the effective application of the policies, systems and activities related to internal control and risk management? How has the board assessed the effectiveness of these processes?

- How has the board satisfied itself that the risk management systems are designed in such a way as to ensure that risk is managed holistically and not in silos?

- How are processes/controls adjusted to reflect new or changing risks, or operational deficiencies?

- What sources of assurance does the board rely on? How has it assessed their effectiveness?

- Is the board satisfied that the information being received from management and others is timely and fit for purpose?

- How are the board's information needs and related information systems reassessed as objectives and related risks change or as reporting deficiencies are identified?

- Where activities have been delegated to board committees, has the board assessed whether those arrangements are working effectively?

- How are material control weaknesses or failures dealt with? What follow-up procedures are in place to ensure that appropriate change or action occurs in response to changes in risk and control assessments?

- What are the responsibilities of the board and senior management for crisis management?

- How effectively have the company's crisis management systems been tested?

Public reporting

- How has the board satisfied itself that reports to shareholders on risk and internal controls are fair, balanced and understandable, and provide them with the information they need to assess the company's performance, business model and strategy?

- Is there a clear read across between reporting on principal risks and uncertainties in the Strategic Report and the going concern assessment in the financial statements?

APPENDIX E

WARNING SIGNS

This Appendix is intended to assist boards in assessing how well they are exercising their responsibilities for risk; whether the culture of the company is what they would wish it to be; and whether the risk management and internal control system is operating effectively.

Boards should identify indicators that might suggest failures or weaknesses in one or more of these areas, which would prompt them to consider whether action was needed to address the issue. Some suggested indicators are listed below. As with the questions in Appendix D, they are not intended to be exhaustive and not all will be appropriate in all circumstances, but will need to be tailored to the company.

Effectiveness of the board and committees

- Insufficient breadth of experience and expertise in the board or board committee.
- Delegating too much responsibility to board committees so that some directors are not involved.
- Lack of clarity about which board committee is responsible for ensuring reward schemes reflect the company's approach to risk.
- Non-executive directors not getting out and about enough to really understand the business and its people.
- Board papers and processes that cause time to be used unproductively.
- A lack of understanding of the risks inherent in the company's business model.

The right culture

- A culture where people are reluctant to admit mistakes and do not welcome challenge.
- Failure to communicate a consistent attitude to risk and mitigation.
- Inability to assess if employees are listening to or understanding what the board is saying.
- Senior management does not give a clear lead on risk management and visibly support the risk and internal audit functions.
- Misaligned incentives that encourage either inappropriate risk-taking or excessive risk aversion.
- Risk managers and internal auditors are prevented from addressing risks emanating from the upper echelons of the company.
- An inability to stop bad projects once they have gathered momentum.
- Significant regulatory problems

Effectiveness of the risk management and internal control system

- Managers who might not see the need for the more formal processes that the board needs if its oversight is to be effective.
- Unclear lines of accountability.
- Defective internal communication and information flows.
- Mechanical and static processes.
- Organisational complexity.
- Risks associated with major transactions or projects not adequately assessed or discussed at board level

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