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# Guidance on Risk Management, Internal Control and Related Financial and Business Reporting

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# Section 1

## Introduction

### *Applicability*

1. This guidance revises, integrates and replaces the current editions of the Financial Reporting Council's ("FRC") 'Internal Control: Revised Guidance for Directors on the Combined Code' and 'Going Concern and Liquidity Risk: Guidance for Directors of UK Companies', and reflects changes made to the UK Corporate Governance Code ("the Code").
2. It aims to bring together elements of best practice for risk management; prompt boards to consider how to discharge their responsibilities in relation to the existing and emerging principal risks faced by the company; reflect sound business practice, whereby risk management and internal control are embedded in the business process by which a company pursues its objectives; and highlight related reporting responsibilities.
3. While it is hoped that this guidance will be useful to other entities, it is primarily directed to companies subject to the Code.<sup>1</sup> It applies to such companies for accounting periods beginning on or after 1 October 2014.

### *Background*

4. 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". Effective development and delivery of a company's strategic objectives, its ability to seize new opportunities and to ensure its longer term survival depend upon its identification, understanding of, and response to, the risks it faces.
5. 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 company's strategy and managing its risks. There may be significant consequences if the company does not do so effectively.
6. Good stewardship by the board should not inhibit sensible risk taking that is critical to growth. However, the assessment 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 ensure that shareholders and other stakeholders are well informed about the principal risks and prospects of the company.<sup>2</sup> The board's responsibility for the organisation's culture is essential to the way in which risk is considered and addressed within the organisation and with external stakeholders.

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<sup>1</sup> The UK Corporate Governance Code applies to all companies with a Premium listing of equity shares on the London Stock Exchange regardless of whether they are incorporated in the UK or elsewhere.

<sup>2</sup> Principal risks are defined in the Guidance on the Strategic Report (2014) – see: <https://www.frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/Guidance-on-the-Strategic-Report.pdf>. A principal risk is a risk or combination of risks that can seriously affect the performance, future prospects or reputation of the entity. These should include those risks that would threaten its business model, future performance, solvency or liquidity.

7. The Code was updated in 2010 to make it clear that, in addition to being responsible for ensuring sound risk management and internal control systems, boards should explain the company's business model and should determine the nature and extent of the principal risks they were willing to take to achieve the company's strategic objectives.
8. The Code was further updated in 2012 to improve financial and business reporting by making it clear that the board should:
  - confirm 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 position and performance, business model and strategy; and
  - establish arrangements that will enable it to make this assessment.
9. In 2011 the FRC published the 'Boards and Risk' report, which reflected the views of directors, investors and risk professionals and highlighted that the board's responsibilities for risk management and internal control are not limited to the oversight of the internal control system.
10. In 2012 the Sharman Inquiry into going concern and liquidity risk concluded that the board's declaration of whether the company remained a going concern should be more broadly based than is required to determine the accounting approach to be taken.
11. 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 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 and review of the associated systems, 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; the disclosures on the going concern basis of accounting and material uncertainties thereto; and the report on the review of the risk management and internal control systems.

12. In April 2014 the FRC also published its 'Guidance on the Strategic Report' as best practice<sup>3</sup>. It encourages companies to make the information in annual reports more relevant to shareholders. Recognising that an annual report comprises a number of components, it aims to promote cohesiveness amongst these components, with related information appropriately linked together.

### ***Risk Management and Internal Control***

13. The board has ultimate responsibility for risk management and internal control, including for the determination of the nature and extent of the principal risks it is willing to take to achieve its strategic objectives and for ensuring that an appropriate culture has been embedded throughout the organisation. This guidance provides a high-level overview of some of the factors boards should consider in relation to the design, implementation, monitoring and review of the risk management and internal control systems. Such systems cannot eliminate all risks, but it is the role of the board to ensure that they are robust and effective and take account of such risks.
14. Consistent with the amendment to Principle C.2 in the 2014 edition of the Code, this guidance asks boards to determine their "principal" risks, rather than "significant" risks as in earlier Code editions. This decision was taken to align the terminology with the new Strategic Report requirements. The term "principal risk" is defined in the FRC's 'Guidance on the Strategic Report'. The FRC considers that in this context the words "principal" and "significant" are interchangeable and that the amendment should not be seen as implying a change in the nature of the risks referred to in Principle C.2.
15. The guidance does not set out in detail the procedure by which a company designs and implements its risk management and internal control systems. Attempting to define a single approach to achieving best practice would be misguided if it led boards to underestimate the crucial importance to high quality risk management of the culture and behaviour they promote.

### ***The Board's Statements on Longer Term Viability and on the Going Concern Basis of Accounting***

16. The Sharman Inquiry concluded that the board's assessment as to whether a company remains a "going concern" should be more broadly based than is required to determine whether to adopt the going concern basis of accounting in the current financial statements and identify any material uncertainties about the company's ability to continue to do so in future.
17. The revised Code and this guidance use the term "going concern" only in the context of referring to the going concern basis of accounting for the preparation of financial statements, as defined in accounting standards. This usage is well-established but is different from the ordinary English usage of the term "going concern" to describe an entity that has a viable future.

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<sup>3</sup> The Companies Act 2006 requires companies to provide a Strategic Report.

18. In the 2014 edition of the Code, Provision C.1.3 has been revised to require an explicit statement in the financial statements about whether: the going concern basis of accounting has been adopted; and there are any material uncertainties about the company's ability to continue to do so in future. A new provision (C.2.2) requires a broader statement about the board's reasonable expectation as to the company's viability based on a robust assessment of the company's principal risks and the company's current position. This guidance addresses each of these statements.

### ***How this Guidance is Structured***

19. Sections 2 and 3 of this guidance summarise the board's responsibilities for risk management and internal control and identify some of the factors boards should consider in order to exercise those responsibilities effectively. Section 4 addresses the establishment of the risk management and internal control systems, Section 5 discusses the monitoring and review of those systems and Section 6 addresses the board's related financial and business reporting responsibilities.
20. Sections 4, 5 and 6 incorporate the core of the previous 'Internal Control: Guidance for Directors'. Sections 2 and 3 are new, and are intended to align the scope of the guidance with Principle C.2 on Risk Management and Internal Control and Provision C.1.3 on the going concern basis of accounting, by addressing the full range of the board's responsibilities for these matters and their inter-relationships.
21. Appendices A and B provide further guidance on adopting the going concern basis of accounting and related disclosures and on the longer term viability statement. In addition, the FRC has issued a separate Supplement for Banks on going concern, which addresses considerations specific to the banking sector, and which should be read in conjunction with this Guidance.
22. Appendix C contains questions that may assist boards in assessing how they are carrying out their responsibilities, the culture of the company, and the effectiveness of the risk management and internal control systems.
23. Appendix D contains an overview of a company's reporting requirements relating to risk and going concern.



## Section 2

### Board Responsibilities for Risk Management and Internal Control

24. The board has responsibility for an organisation's overall approach to risk management and internal control. The board's responsibilities are:
- ensuring the design and implementation of appropriate risk management and internal control systems that identify the risks facing the company and enable the board to make a robust assessment of the principal risks;
  - determining the nature and extent of the principal risks faced and those risks which the organisation is willing to take in achieving its strategic objectives (determining its "risk appetite");
  - ensuring that appropriate culture and reward systems have been embedded throughout the organisation;
  - agreeing how the principal risks should be managed or mitigated to reduce the likelihood of their incidence or their impact;
  - monitoring and reviewing the risk management and internal control systems, and the management's process of monitoring and reviewing, and satisfying itself that they are functioning effectively and that corrective action is being taken where necessary; and
  - ensuring sound internal and external information and communication processes and taking responsibility for external communication on risk management and internal control.
25. The board's specific responsibility for determining whether to adopt the going concern basis of accounting and related disclosures of material uncertainties in the financial statements is a sub set of these broader responsibilities. A company that is able to adopt the going concern basis of accounting and does not have related material uncertainties to report, for the purposes of the financial statements, is not necessarily free of risks that would threaten the company's business model, future performance, solvency or liquidity were they to materialise. The board is responsible for ensuring this distinction is understood internally and communicated externally.
26. It is the role of management to implement and take day-to-day responsibility for board policies on risk management and internal control. But the board needs to satisfy itself that management has 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 internal responsibilities and accountabilities are clearly established, understood and embedded at all levels of the organisation. Employees should understand their responsibility for behaving according to the culture.

## Section 3

### Exercising Responsibilities

27. The board should establish the tone for risk management and internal control and put in place appropriate systems to enable it to meet its responsibilities effectively. 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 the company faces. But in deciding what arrangements are appropriate the board should consider, amongst other things:

- The culture it wishes to embed 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 depend on the individuals responsible for operating the systems that are put in place. In order to ensure the appropriate 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 style and management structures, human resource policies and reward systems support or undermine the risk management and internal control systems.

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

The board should agree the frequency and scope of its discussions on strategy, business model and risk; how its assessment of risk 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 needs to ensure that it engages in informed debate and constructive challenge and keeps under review the effectiveness of its decision-making processes.

- The skills, knowledge and experience of the board and management.

The board should consider whether it, and any committee or management group to which it delegates activities, has the necessary skills, knowledge, experience, authority and support to enable it to assess the risks the company faces and exercise its responsibilities effectively. Boards should consider specifically assessing this as part of their regular evaluations of their effectiveness.

- 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. It should ensure that the assumptions and models underlying this information are clear so that they can be understood and if necessary challenged. Risks can crystallise quickly and the board should ensure that there are clear processes for bringing significant issues to its attention more rapidly when required, and agreed triggers for doing so.

The board should monitor the quality of the information it receives and ensure that it is of a sufficient quality to allow effective decision-making.

- The use, if any, made of delegation.

The board should determine to what extent it wishes to delegate some activity to, or obtain advice from, committees or the management group and the appropriate division of responsibilities and accountabilities.

To the extent that designated committees or the management group carry out, on behalf of the board, activities that this guidance attributes to the board, the board should be satisfied that the arrangements for the work carried out, for the co-ordination of their work (if more than one is involved), and for reporting to the board are appropriate and operating effectively. The board retains ultimate responsibility for the risk management and internal control systems and should reach its own conclusions regarding the recommendations it receives.

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

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

## Section 4

### Establishing the Risk Management and Internal Control Systems

28. The risk management and internal control systems encompass the policies, culture, organisation, behaviours, processes, systems and other aspects of a company that, taken together:
- facilitate its effective and efficient operation by enabling it to assess current and emerging risks, respond appropriately to risks and significant control failures and to safeguard its assets;
  - help to reduce the likelihood and impact of poor judgement in decision-making; risk-taking that exceeds the levels agreed by the board; human error; or control processes being deliberately circumvented;
  - help ensure the quality of internal and external reporting; and
  - help ensure compliance with applicable laws and regulations, and also with internal policies with respect to the conduct of business.
29. A company's systems of risk management and internal control will include: risk assessment; management or mitigation of risks, including the use of control processes; information and communication systems; and processes for monitoring and reviewing their continuing effectiveness.
30. The risk management and internal control systems should be embedded in the operations of the company and be capable of responding quickly to evolving business risks, whether they arise from factors within the company or from changes in the business environment. These systems should not be seen as a periodic compliance exercise, but instead as an integral part of the company's day to day business processes.
31. The board should ensure that sound risk management and internal control systems are in place to identify the risks facing the company and to consider their likelihood and impact if they were to materialise.
32. When determining the principal risks, the board should focus on those risks that, given the company's current position, could threaten the company's business model, future performance, solvency or liquidity, irrespective of how they are classified or from where they arise. The board should treat such risks as principal risks and establish clearly the extent to which they are to be managed or mitigated.
33. Risks will differ between companies but may include financial, operational, reputational, behavioural, organisational, third party, or external risks, such as market or regulatory risk, over which the board may have little or no direct control.
34. The design of a robust assessment process to determine the principal risks and consider their implications for the company 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, operational processes and the stage of development the company has reached in its own business cycles, as well as with changes in the external environment.

35. When considering risk the board should consider the following aspects:
- the nature and extent of the risks, including principal risks, facing, or being taken by, the company which it regards as desirable or acceptable for the company to bear;
  - the likelihood of the risks concerned materialising, and the impact of related risks materialising as a result or at the same time;
  - the company's ability to reduce the likelihood of the risks materialising, and of the impact on the business of risks that do materialise;
  - the exposure to risks before and after risks are managed or mitigated, as appropriate;
  - the operation of the relevant controls and control processes;
  - 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 systems.
36. Training and communication assist in embedding the desired culture and behaviours in the company. To build a company culture that recognises and deals with risk, it is important that the risk management and internal control systems consider how the expectations of the board are to be communicated to staff and what training may be required. In considering communication systems, the board should also consider the company's whistle-blowing procedures.
37. Effective controls are an important element of the systems of risk management and internal control and can cover many aspects of a business, including strategic, financial, operational and compliance.
38. The board should agree how the principal risks will be managed or mitigated and which controls will be put in place. In agreeing the controls the board should determine what constitutes a significant control failing.

## Section 5

### Monitoring and Review of the Risk Management and Internal Control Systems

39. The existence of risk management and internal control systems does not, on its own, signal the effective management of risk. Effective and on-going monitoring and review are essential components of sound systems of risk management and internal control. The process of monitoring and review is intended to allow the board to conclude whether the systems are properly aligned with strategic objectives; and satisfy itself that the systems address the company's risks and are being developed, applied and maintained appropriately.
40. The board should define the processes to be adopted for its on-going monitoring and review, including specifying the requirements, scope and frequency for reporting and assurance. Regular reports to the board should provide a balanced assessment of the risks and the effectiveness of the systems of risk management and internal control in managing those risks. 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.
41. When reviewing reports during the year, the board should consider: how effectively the risks have been assessed and the principal risks determined; how they have been managed or mitigated; 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, a need for more extensive monitoring or a reassessment of the effectiveness of management's on-going processes.
42. In addition to its on-going monitoring and review, the board should undertake an annual review of the effectiveness of the systems 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 review, including drawing on the results of the board's on-going process such that it will obtain sound, appropriately documented, evidence to support its statement in the company's annual report and accounts.
43. The annual review of effectiveness should, in particular, consider:
  - the company's willingness to take on risk (its "risk appetite"), the desired culture within the company and whether this culture has been embedded;
  - the operation of the risk management and internal control systems, covering the design, implementation, monitoring and review and identification of risks and determination of those which are principal to the company;
  - the integration of risk management and internal controls with considerations of strategy and business model, and with business planning processes;
  - the changes in the nature, likelihood and impact of principal risks, and the company's ability to respond to changes in its business and the external environment;
  - the extent, frequency and quality of the communication of the results of management's monitoring to the board 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 or mitigated;

- 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, or could have, resulted in unforeseen impact; and
- the effectiveness of the company's public reporting processes.

## Section 6

### Related Financial and Business Reporting

44. The assessment and processes set out in this guidance should be used coherently to inform a number of distinct but related disclosures in the annual report and accounts. These are:
- reporting on the principal risks facing the company and how they are managed or mitigated (as required by the Companies Act 2006 (the “Companies Act”) and the Code);
  - reporting on whether the directors have a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due (as required by the Code);
  - reporting on the going concern basis of accounting (as required by accounting standards and the Code); 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 UK Listing Authority’s Disclosure and Transparency Rules).
45. The purpose of such reporting is to provide information about the company’s current position and prospects and the principal risks it faces. 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.
46. As with all parts of the annual report and accounts, the board should provide clear and concise information that is tailored to the specific circumstances material to the company, and should avoid using standardised language which may be long on detail but short on insight. In considering how to meet the different disclosures summarised below, the board should bear in mind the need for the annual report and accounts as a whole to be fair, balanced and understandable.
47. For groups of companies, all reporting should be from the perspective of the group as a whole. An explanation should be given of how the board assesses and manages the risks faced in relation to investments in material joint ventures and associates. Where the board does not have access to, and oversight of, detailed information concerning those entities’ business planning, risk management and internal controls, this fact should also be disclosed.

### ***Principal risks***

48. The Companies Act requires companies to publish a Strategic Report that must include “a fair review of the company’s business, and a description of the principal risks and uncertainties facing the company”. The Code states that the board should confirm that it has carried out a robust assessment of the principal risks and that the board should describe those risks and explain how they are being managed or mitigated (Provision C.2.1).
49. A risk or uncertainty may be unique to the company, 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 company specifically.

50. 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 the circumstances under which the risk might be most relevant to the company and its possible impacts. Significant changes in principal risks such as a change in the likelihood or possible impact, 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.

### ***Reasonable expectation that the company can continue in operation***

51. Provision C.2.2 of the Code requires that the directors should explain in the annual report – taking account of the company's current position and principal risks – how they have assessed the prospects of the company, over what period they have done so and why they consider that period to be appropriate. They should also state whether they have a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, drawing attention to any qualifications or assumptions as necessary. Further guidance is provided in Appendix B.
52. There is likely to be a degree of overlap with the disclosures on principal risks and any material uncertainties relating to the going concern basis of accounting, and companies should consider how best to link them.

### ***Going concern basis of accounting and related disclosures***

53. Accounting standards require companies 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.
54. Provision C.1.3 of the Code states that the directors should make an explicit statement of whether they considered it appropriate to adopt the going concern basis of accounting in preparing the annual and half-yearly financial statements.
55. Accounting standards also require companies to make an assessment of their ability to continue to adopt the going concern basis of accounting and to disclose any material uncertainties identified. In performing this assessment, the directors should consider all available information about the future, the possible outcomes of events and changes in conditions and the realistically possible responses to such events and conditions that would be available to the directors.
56. The Code states that the directors should identify in the financial statements any such material uncertainties over a period of at least twelve months from the date of approval of those financial statements. Further guidance on adopting and reporting on the going concern basis of accounting and disclosures on material uncertainties to be included in the financial statements is provided in Appendix A.

## ***Statement on risk management and internal control***

57. Provision C.2.3 of the Code states that the board should report in the annual report and accounts on its review of the effectiveness of the company's risk management and internal control systems. In its statement the board should, as a minimum, acknowledge: that it is responsible for those systems and for reviewing their effectiveness and disclose:
- that there is an on-going process for identifying, evaluating and managing the principal risks faced by the company;
  - that the systems have been in place for the year under review and up to the date of approval of the annual report and accounts;
  - that they are regularly reviewed by the board; and
  - the extent to which the systems accord 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. Where this information has been disclosed elsewhere in the annual report and accounts, for example in the audit committee report, a cross-reference to where that information can be found would suffice. In reporting on these actions, the board would not be expected to disclose information which, in its opinion, would be prejudicial to its interests.
59. The statement should incorporate, 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.
60. 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 it in their report. 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 in the Strategic Report and material uncertainties relating to the going concern basis of accounting in the financial statements.

## ***Safe Harbour Provision in relation to the Strategic Report, Directors' Report and the Directors' Remuneration Report***

61. In considering where and how to report, the board is likely to find it helpful to be mindful of its legal duties and the so-called safe harbour afforded it.
62. Section 463 of the Companies Act provides that directors are liable to compensate the company if the company suffers any loss as the result of any untrue or misleading statement in (or any omission from) the Strategic Report, the Directors' Remuneration Report or the Directors' Report. The extent of the liability is limited: directors are only liable to the company. Further, directors are only liable to the company if they knew that the statements were untrue or misleading or if they knew that the omission was a dishonest concealment of a material fact. This protection is sometimes known as 'safe harbour'.

63. Accordingly, provided directors do not issue a deliberately or recklessly untrue or misleading statement or dishonestly conceal a material fact by way of an omission, they will not be liable to compensate the company for any loss incurred by it in reliance on the report.
64. In order to benefit from this protection, it is generally accepted that directors should ensure that information required in one of the three specified reports is included in those reports, either directly or via a specific cross-reference.
65. The exact scope and extent of the protection (including whether it extends to information included in a report on a voluntary basis) has not been tested in court and hence the legal position in relation to the inclusion of such information remains uncertain.

## Appendix A

### Going Concern Basis of Accounting and Material Uncertainties

#### *Determining whether to adopt the going concern basis of accounting*

1. 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.
2. Accordingly, the threshold for departing from the going concern basis of accounting is a very high hurdle, as there are often realistic alternatives to liquidation or cessation of trading even when material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern have been identified.
3. Provision C.1.3 of the Code requires that the directors make an explicit statement in annual and half-yearly financial statements whether they considered it appropriate to adopt the going concern basis of accounting in preparing the financial statements, and in identifying any material uncertainties to its ability to continue to do so.

#### *Determining whether there are material uncertainties*

4. Accounting standards also require an assessment to be made of the entity's ability to continue to adopt the going concern basis of accounting.<sup>4</sup> In performing this assessment, the directors should consider all available information about the future, the possible outcomes of events and changes in conditions and the realistically possible responses to such events and conditions that would be available to the directors.
5. Events or conditions might result in the use of the going concern basis of accounting being inappropriate in future reporting periods. As part of their assessment, the directors should determine if there are any material uncertainties relating to events or conditions that might cast significant doubt upon the continuing use of the going concern basis of accounting in future periods. Uncertainties relating to such events or conditions should be considered material, and therefore disclosed, if their disclosure could reasonably be expected to affect the economic decisions of shareholders and other users of the financial statements. This is a matter of judgement. In making this judgement, the directors should consider the uncertainties arising from their assessment, both individually and in combination with others.
6. In determining whether there are material uncertainties, the directors should consider:
  - the magnitude of the potential impacts of the uncertain future events or changes in conditions on the company and the likelihood of their occurrence;
  - the realistic availability and likely effectiveness of actions that the directors would consider undertaking to avoid, or reduce the impact or likelihood of occurrence, of the uncertain future events or changes in conditions; and

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<sup>4</sup> IAS 1 paragraphs 25 and 26.

- whether the uncertain future events or changes in conditions are unusual, rather than occurring with sufficient regularity to make predictions about them with a high degree of confidence.
7. Uncertainties should not usually be considered material if the likelihood that the company will not be able to continue to use the going concern basis of accounting is assessed to be remote, however significant the assessed potential impact.

### ***Reporting on the going concern basis of accounting and material uncertainties***

8. To be useful the disclosures of material uncertainties must explicitly identify that they are material uncertainties that may cast significant doubt upon the entity's ability to continue to apply the going concern basis of accounting.<sup>5</sup> Provision C.1.3 of the Code requires that the directors identify in the financial statements any such material uncertainties over a period of at least twelve months from the date of approval of the financial statements.<sup>6</sup>
9. In the annual financial statements, three reporting scenarios follow from the directors' assessment of whether to adopt the going concern basis of accounting and whether there are material uncertainties:
- the going concern basis of accounting is appropriate and there are no material uncertainties. The directors should adopt the going concern basis of accounting as part of the company's financial statements, make an explicit statement that the adoption of the going concern basis of accounting is considered appropriate and make any disclosures necessary to give a true and fair view; or
  - the going concern basis of accounting is appropriate but there are material uncertainties. The directors should adopt the going concern basis of accounting in preparing the financial statements, make an explicit statement that the adoption of the going concern basis of accounting is considered appropriate, disclose and identify any material uncertainties and make any other disclosures necessary to give a true and fair view; or
  - the going concern basis of accounting is not appropriate. Such a conclusion is likely to be rare. The directors should make an explicit statement that the adoption of the going concern basis of accounting is not considered appropriate, disclose the basis of accounting adopted and make any other disclosures necessary to give a true and fair view.

### ***Half-yearly financial statements***

10. Where an entity is required to prepare half-yearly financial statements,<sup>7</sup> 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.

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<sup>5</sup> IFRIC Update July 2010.

<sup>6</sup> IAS 1 paragraph 26 requires that the minimum period considered be at least, but not limited to, twelve months from the reporting date. FRS 102 paragraph 3.8 requires that the minimum period considered be at least, but not limited to, twelve months from the date the financial statements are authorised for issue.

<sup>7</sup> Companies listed on a regulated market are required under the Disclosure and Transparency Rules to produce half-yearly financial reports.

Directors 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.

## Appendix B

### Longer Term Viability Statement

1. Provision C.2.2 of the Code requires that the directors should explain in the annual report – taking account of the company's current position and principal risks – how they have assessed the prospects of the company, over what period they have done so and why they consider that period to be appropriate. They should also state whether they have a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, drawing attention to any qualifications or assumptions as necessary. This statement is intended to express the directors' view about the longer term viability of the company over an appropriate period of time selected by them.

#### ***Reasonable expectation and period covered***

2. Reasonable expectation does not mean certainty. It does mean that the assessment can be justified. The longer the period considered, the more the degree of certainty can be expected to reduce.
3. That does not mean that the period chosen should be short. Except in rare circumstance it should be significantly longer than 12 months from the approval of the financial statements. The length of the period should be determined, taking account of a number of factors, including without limitation: the board's stewardship responsibilities; previous statements they have made, especially in raising capital; the nature of the business and its stage of development; and its investment and planning periods.
4. The statement should be based on a robust assessment of those risks that would threaten the business model, future performance, solvency or liquidity of the company, including its resilience to the threats to its viability posed by those risks in severe but plausible scenarios. Such an assessment should include sufficient qualitative and quantitative analysis, and be as thorough as is judged necessary to make a soundly based statement. Stress and sensitivity analysis will often assist the directors in making their statement. These simulation techniques may help in assessing both the company's overall resilience to stress and its adaptability and the significance of particular variables to the projected outcome.
5. The directors should consider the individual circumstances of the company in tailoring appropriate analysis best suited to its position and performance, business model, strategy and principal risks. These should be undertaken with an appropriate level of prudence, i.e. weighting downside risks more heavily than upside opportunities. This may include analysis of reverse stress, starting from a presumption of failure and seeking to identify the circumstances in which this could occur.

#### ***Ability to continue in operation and meet liabilities as they fall due***

6. Directors are encouraged to think broadly as to relevant matters which may threaten the company's future performance and so its ability to continue in operation and remain viable. Directors should consider risks to solvency (the company's ability to meet its financial liabilities in full), as well as liquidity (the ability to meet such liabilities as they fall due) – which may be a timing issue even if the entity appears to be solvent over time – and other threats to the company's viability.

7. The board's consideration of whether a risk or combination of risks could lead to an inability to continue in operation should take full account of the availability and likely effectiveness of actions 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. In considering the likely effectiveness of such actions, the conclusions of the board's regular monitoring and review of risk and internal control systems should be taken into account.

### ***Qualifications or assumptions***

8. Any qualifications or assumptions to which the directors consider it necessary to draw attention in their statement should be specific to the company's circumstances, rather than so generic that they could apply to any predictions about the future. They should be relevant to an understanding of the directors' rationale for making the statement. They should only include matters that are significant to the company's prospects and should not include matters that are highly unlikely either to arise or to have a significant impact on the company. Where relevant, they should cross-refer to, rather than repeat, disclosures given elsewhere.



## **Appendix C**

### **Questions for the Board to Consider**

Questions which the board may wish to consider and discuss with management and others such as the risk or internal audit functions are set out below. If the answers to the questions pose concern for the board it may wish to consider whether action is needed to address possible failings. The questions are not intended to be exhaustive and not all will be appropriate in all circumstances, but should be tailored to the company.

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

#### ***Risk appetite and culture***

- How has the board agreed the company's risk appetite? With whom has it conferred?
- How has the board assessed the company's culture? In what way does the board satisfy itself that the company has a 'speak-up' culture and that it systematically learns from past mistakes?
- How 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 systems?
- How has the board considered whether senior management promotes and communicates the desired culture and demonstrates the necessary commitment to risk management and internal control?
- How is inappropriate behaviour dealt with? Does this present consequential risks?
- 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?

#### ***Risk management and internal control systems***

- To what extent do the risk management and internal control systems underpin and relate to the company's business model?
- How are authority, responsibility and accountability for risk management and internal control defined, co-ordinated and documented throughout the organisation? How does the board determine whether this is clear, appropriate and effective?
- How effectively is the company able to withstand risks, and risk combinations, which do materialise? How effective is the board's approach to risks with 'low probability' but a very severe impact if they materialise?
- How has the board assessed whether employees have the knowledge, skills and tools to manage risks effectively?
- What are the channels of communication that enable individuals, including third parties, to report concerns, suspected breaches of law or regulations, other improprieties or challenging perspectives?

- How does the board satisfy itself that the information it receives is timely, of good quality, reflects numerous information sources and is fit for purpose?
- What are the responsibilities of the board and senior management for crisis management? How effectively have the company's crisis management planning and systems been tested?
- To what extent has the company identified risks from joint ventures, third parties and from the way the company's business is organised? How are these managed?
- How effectively does the company capture new and emerging risks and opportunities?
- How and when does the board consider risk when discussing changes in strategy or approving new transactions, projects, products or other significant commitments?
- To what extent has the board considered the cost-benefit aspects of different control options?
- How does the board ensure it understands 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?

### ***Monitoring and Review***

- What are the processes by which senior management monitor the effective application of the systems of risk management and internal control?
- In what way do the monitoring and review processes take into account the company's ability to re-evaluate the risks and adjust controls effectively in response to changes in its objectives, its business, and its external environment?
- How are processes or controls adjusted to reflect new or changing risks, or operational deficiencies? To what extent does the board engage in horizon scanning for emerging risks?

### ***Public reporting***

- How has the board satisfied itself that the disclosures on risk management and internal control contribute to the annual report being fair, balanced and understandable, and provide shareholders with the information they need?
- How has the board satisfied itself that its reporting on going concern and the longer term viability statement gives a fair, balanced and understandable overview of the company's position and prospects?

## Appendix D

### UK Corporate Governance Code and Other Regulatory Requirements

#### *UK Corporate Governance Code (2014 edition)*

##### Section C: Accountability

Principle C.1: Financial and Business Reporting: *The board should present a fair, balanced and understandable assessment of the company's position and prospects.*

Provision C.1.3: *In annual and half-yearly financial statements, the directors should state whether they considered it appropriate to adopt the going concern basis of accounting in preparing them, and identify any material uncertainties to the company's ability to continue to do so over a period of at least twelve months from the date of approval of the financial statements.*

Principle C.2: Risk Management and Internal Control: *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: *The directors should confirm in the annual report that they have carried out a robust assessment of the principal risks facing the company, including those that would threaten its business model, future performance, solvency or liquidity. The directors should describe those risks and explain how they are being managed or mitigated.*

Provision C.2.2: *Taking account of the company's current position and principal risks, the directors should explain in the annual report how they have assessed the prospects of the company, over what period they have done so and why they consider that period to be appropriate. The directors should state whether they have a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due over the period of their assessment, drawing attention to any qualifications or assumptions as necessary.*

Provision C.2.3: *The board should monitor the company's risk management and internal control systems and, at least annually, carry out a review of their effectiveness, and report on that review in the annual report. 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 Companies 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”.<sup>8</sup>

## **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 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 Code and whether they have complied with its provisions. Where they have not complied with a provision, they are required to explain the reason.

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”. The FRC has contacted the Financial Conduct Authority and companies should use this guidance for reporting years starting on or after 1 October 2014 whilst the reference to out of date guidance is being updated.

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<sup>8</sup> FRC Guidance on the Strategic Report: <https://www.frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/Guidance-on-the-Strategic-Report.pdf>.

## ***Accounting Standards***

Paragraph 25 of International Accounting Standard 1 (IAS 1)<sup>9</sup> 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”.

## ***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.

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<sup>9</sup> The equivalent requirement under UK GAAP is in paragraphs 3.8 – 3.9 of FRS 102.



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