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By email only to: riskreview@frc.org.uk

Dear Ms Woods

Consultation on Draft Guidance: Risk Management, Internal Control and the Going Concern Basis of Accounting

Deloitte LLP is pleased to respond to the Financial Reporting Council's (FRC's) request for comments on the Consultation on Draft Guidance: Risk Management, Internal Control and the Going Concern Basis of Accounting.

We welcome the principles behind the consultation as:

- improving the quality of risk management and internal control of companies applying the UK Corporate Governance Code ("the Code"); and
- enhancing the communication between those companies and their shareholders on the company's approach to risk management, internal control and going concern.

Overall, we support the FRC's proposed changes to the Code and the associated guidance and believe that these changes represent existing good practice in risk management and internal control. We believe that in most cases companies should be seeking to meet these standards as a matter of good business practice rather than as a purely regulatory compliance exercise. Whilst we acknowledge that the Guidance stresses the importance of proportionality, we believe there may be additional costs for smaller listed companies. It is hoped that any costs will be outweighed by the benefits of companies which are well managed and in a better position to address significant shocks to their business models. We also hope that the proposals will enhance the reputation of London as a place where good quality companies seek to list.

The answers to your questions are included in the Appendix to this letter. Our key comments, which we expand on in the Appendix, are as follows.

Comments on the Draft Guidance: Risk Management, Internal Control and the Going Concern Basis of Accounting

- We believe that there are still opportunities to clarify the drafting of the Guidance; in particular, we suggest (a) the reintroduction of a table summarising the various situations that a company may find itself in in terms of narrative reporting and the going concern basis of accounting and (b) inclusion of a “definitions” section to highlight where key terms are defined in the Guidance.
- There is a need to define the term “significant failings or weaknesses” in light of the proposal that boards should explain what actions have been or are being taken to remedy any significant failings or weaknesses. Lack of clarity in this area could lead to a wide range of interpretations which will lessen the value of these disclosures for shareholders and the assurances provided.
- We acknowledge that stress testing and sensitivity analysis can be important components of good risk management but not all companies have the resources and capabilities to undertake the analysis as recommended by the Guidance. It would be helpful to those companies if the Guidance could provide an indication of the circumstances under which such stress testing and sensitivity analysis would be of most benefit to the company.
- Appendix C provides additional guidance which is potentially more restrictive than IAS 1 regarding identifying and reporting on material uncertainties and adoption of the going concern basis of accounting. Whilst we understand the FRC’s intentions, we believe any standard or interpretation in this area should continue to be issued by the IASB in order to maintain comparability between entities applying International Financial Reporting Standards.
- Appendices D and E could be redrafted to be more accessible to all sizes of entities that apply the Code (we included an illustration of this in Appendix 2 to this letter).

Comments on the Guidance for Directors of Banks on Solvency and Liquidity Risk Management and the Going Concern Basis of Accounting

- We are supportive of the FRC’s proposals. We suggest that the wider Guidance include reminders of the importance of discussions between auditors, audited entities and regulators for other types of financial institution.

Comments on the Revised Auditing Standards (extracts) ISAs (UK and Ireland) 260, 570, 700

- We recommend that the FRC takes the opportunity to lead the international debate by requiring an explicit, positive statement on going concern in auditors’ reports. . Rather than a negative statement which can still leave room for ambiguity, we consider that this gives genuine clarity to shareholders and is the best and clearest way for the auditor to report on going concern as part of the audit. We already include such a positive statement alongside the changes mandated by the June 2013 revision of ISA (UK & Ireland) 700; this has been positively received by investors.
- We agree that auditors should consider if there is anything “material to add” in relation to the directors’ statement on risk assessment. We suggest that this duty would be best combined with the auditor’s existing duty to report whether or not they auditor disagrees with other parts of the narrative, including the statement that the annual report is “fair, balanced and understandable”. However, we do not support the “anything material to draw attention to” part of the proposal. The FRC’s Exposure Draft: Guidance on the Strategic Report and the past few annual reports of the FRC’s Conduct Committee (previously the Financial Reporting Review Panel) have reminded directors that the

disclosure of principal risks and uncertainties should always be restricted to those that are genuinely principal. In our view, the FRC's proposal would mean that auditors would always need to draw attention to these disclosures, creating more unnecessary boilerplate in the auditor's report.

We would be happy to discuss our letter and the proposals further. If you have any questions, please contact Tracy Gordon at 020 7007 3812 or trgordon@deloitte.co.uk.

Yours sincerely

A handwritten signature in black ink, appearing to read 'V. Poole', written in a cursive style.

Veronica Poole
National Head of Accounting and Corporate Reporting
Deloitte LLP

Appendix 1: Deloitte's responses to questions raised in the consultation

Question 1 – in relation to the objectives of the draft revised guidance as providing more depth to the guidance on the board's responsibilities for risk management and internal control.

The FRC would welcome views on whether the draft revised guidance achieves these objectives, and on the structure of, and level of detail in, the draft revised guidance.

We agree that the draft revised guidance achieves its stated objectives. Whilst some parts of the guidance are difficult to read in their entirety as the text is quite densely drafted, our view is that the level of detail is suitable for most companies.

There are some areas where we feel the draft revised guidance could be clarified or parts of it made more helpful for a wider range of companies. These have been covered in our responses to other questions.

Question 2 – in relation to Sections 5 and 6 of the draft guidance

Do you agree or are more substantive changes to these sections required?

We agree that sections 5 and 6 of the draft revised guidance are largely unchanged from sections 2 and 3 of the existing guidance. We suggest that one further change could be made to section 5 (with a consequential change to section 3) by referring to the control environment in paragraph 32 of section 5, and making clear in section 3 that the control environment includes the areas in that section. This would more closely align the guidance with the CoSo framework, and indeed with the auditor's approach to internal control set out in ISAs (UK and Ireland).

Question 3 – in relation to the proposed change that, with regard to the review of risk management and control systems, Section 7 of the draft revised guidance encourages the board to “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.

We acknowledge that the existing requirement to confirm that actions have been taken to remedy any significant failings or weaknesses has resulted in boiler plate disclosure which may be of limited use to shareholders. Further, we agree that shareholders will be interested to understand the nature of the most important failings and weaknesses identified and the actions taken to address them.

As noted in the covering letter, there is a need for clarity in the definition of “significant failings or weaknesses”. A suitable definition could be derived from the definition of “significant deficiency” under the Sarbanes-Oxley Act, as “a failing or weakness important enough to merit attention by the board”.

Whilst the material on communication is being updated, it would be helpful to make reference to the FRC's Guidance on the Strategic Report (which will overlap, and should be consistent with, paragraphs 45-49) – and for the relevant section of that guidance to make reference to this guidance for entities applying the UK Corporate Governance Code.

Question 4 – in relation to Appendices D and E

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

We agree that the content of Appendices D and E is of use to directors. An important factor for these appendices is that they should be scalable for use by all sizes of entity applying the Code. To make them more accessible to a wider range of companies, we believe the following would be helpful:

- including additional introductory language explaining how to use the appendices and how to scale them for the needs of each company;
- linking the questions and structure to the Committee of Sponsoring Organisations of the Treadway Commission (“CoSo”) framework which is broadly used by companies to assist in structuring their system of internal controls;
- starting with broader, open ‘category’ questions that can then go into more specific questions – so that a company can either go straight to the detail or determine which categories of question are of relevance to them and focus attention down to the detail accordingly;
- incorporating the questions for the board to consider from Appendix E into linked questions from Appendix D and phrasing them more positively to make sure they get the attention they deserve (so, “Do the board and its committees have the skills, knowledge, experience and support necessary to understand the risks facing the company” could link to the first warning sign in Appendix E, rephrased as “For example, is there sufficient breadth of experience and expertise in the board and each board committee to meet the requirements of their roles?”); and
- removing Appendix E completely, having worked the relevant points into Appendix D.

We have included a brief worked example in Appendix 2 and would be pleased to work further with the FRC in refining the material in the appendices.

Question 5 – in relation to Appendix B

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?

Yes, we consider that the approach is broadly appropriate, although there is some ambiguity regarding what is recommended and for which companies. At a high level of complexity, the type of stress testing and sensitivity analysis discussed in Appendix B is currently performed only by a relatively small number of the largest listed companies.

Some of the concerns expressed by preparers about the complexity of the draft guidance could perhaps be allayed if Appendix B contained a more balanced consideration of the circumstances under which such stress testing and sensitivity analysis would be of most benefit to the company. As drafted, it contains several good reasons to do such analysis and no reasons not to. This may mistakenly give the impression that such analysis is necessary at all times for all entities. We suggest that paragraph 28 of section 4 of the guidance is amended to read “further guidance as to how and when stress testing might be carried out.”

Appendix B is one example as to where the flow of the document could be improved. Sections 1 and 4 have already used the term “solvency and liquidity risk” before any reference is made to Appendix B, which contains the definitions. As set out in the covering letter, a chart and/or glossary would help readers

navigate the guidance. Paragraph 28 might also be moved to go below paragraph 30 to improve the flow, starting “In assessing solvency and liquidity risks, the board should consider...”.

Question 6 – in relation to Appendix C ‘Determining and reporting on the going concern basis of accounting’

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

The guidance in Appendix C goes beyond the current requirements of IAS 1. We do not believe the FRC should introduce additional definitions or interpretations to those produced by the IASB.

We understand that the guidance is intended in part to be an interim solution before any revision of IAS 1 by the IASB. We continue to believe the FRC would be better served by seeking to influence these global initiatives and should only make unilateral changes if international progress is not forthcoming. Any reduction in the international consistency of disclosure is not in the interests of investors and might change the competitiveness of British business in an international market.

The nature of the requirement for rebutting a material uncertainty is also unusual, in that it requires a company to have more confidence in its approach to something which is outside the usual course of business than in its day-to-day decision making. It might be more helpful to express the idea as follows:

- boards already have a level of confidence in the entity’s ability to execute familiar actions, for example a retailer opening and closing branches. Where actions may be necessary that are less familiar - for example closure of a whole division - further thought may be needed before concluding that they are confident that these actions can be executed; and
- as the need for action becomes more urgent, a greater degree of confidence may be needed.

Whilst in the context of Appendix C the table showing examples within or outside the ordinary course of business is valuable, it would be even more useful if a more finely balanced example requiring judgement on the part of the board was presented and discussed.

We also note that two key points in the 2009 Guidance have been lost from the draft guidance:

- The 2009 Guidance was clear that, in the case of half-yearly financial statements, the period for consideration remained twelve months from the date of approval. This point is not in the final paragraph of Appendix C but could usefully be made here (if Appendix C is retained) and in paragraphs 50-53 of Section 7 of the Guidance; indeed, those paragraphs might also bring out this point in respect of the annual report.
- The 2009 Guidance contained helpful material on borrowing facilities (paragraphs 15-16 of the introduction and 34-35 of section 1). This could usefully be reproduced in Appendix C or, if Appendix C is dropped, in the questions on facilities in Appendix D.

Question 7 – in relation to the guidance for banks, revised as necessary to reflect this consultation.

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

Yes. We agree with the FRC’s proposals in relation to banks and continue to welcome the approach the FRC has taken to working with other stakeholders to develop proposals in this area. We stress that it continues to be important that all parties involved recognise that sharing of responsibilities and information is reciprocal.

Whilst banks are different due to the specific nature of their business model, it would be helpful in the case of other strategically important financial institutions such as major insurers if the wider guidance

includes a reminder that, for entities where there are regulatory requirements as to solvency, there may be a need for discussion between auditors, audited entities and regulators.

Question 8 – in relation to the draft revised auditing standards.

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

In relation to ISA (UK and Ireland) 700, we believe that the FRC should drive the international debate by adopting the IAASB's proposals for an explicit report on going concern in auditors' reports. Deloitte has already implemented a positive statement alongside the changes mandated by ISA (UK and Ireland) 700 and this has been positively received by investors. We suggest that this is the best way for auditors to be seen to have considered going concern as part of their audit. As reporting of this nature will in any case be required once the revised Auditing Directive is implemented, we believe it would be helpful to make one change rather than multiple changes in this area.

We believe that the proposed new requirement to “draw attention” to going concern related disclosures in proposed paragraph 22C of ISA (UK and Ireland) will not be helpful to users of the annual report.

- The board's description of principal risks and uncertainties should be restricted to those which are, indeed “principal”. Accordingly, if any solvency or liquidity risk is included within the principal risks, it will by definition be “material” and hence the auditor will need to draw attention to it. This will therefore result in unnecessary boilerplate within the auditor's report. There will also be an emphasis of matter (by virtue of paragraph 19 of ISA (UK and Ireland) 570) if this has given rise to a material uncertainty disclosed under IAS 1.
- If the FRC believes that there should be a more nuanced reporting obligation – the auditor drawing attention to principal risks relating to solvency and liquidity in some but not all cases – then we believe that this would require a different change to be made to the standard. A suitable threshold might be situations where a solvency or liquidity risk was one of those “which had the greatest effect on: the overall audit strategy; the allocation of resources in the audit; and directing the efforts of the engagement team.” – in other words one which the auditor is already required to discuss in their report under paragraph 19A(a) of the standard. This could be achieved by giving such risks as an example in paragraph 13A of the standard.

We agree that the auditor should be required to consider whether they have anything to add to the board's disclosures on going concern. However, auditors will already need to consider this, even without the proposed paragraph 22C. This is because a material omission would mean that:

- (a) the annual report would be unlikely to be fair, balanced and understandable, requiring action under paragraphs 22A and 22B of the existing ISA (UK and Ireland) 700; and
- (b) would most probably be misleading, requiring action under ISA (UK and Ireland) 720 Sections A and/or B.

We suggest that, instead of the FRC's proposed change, the list in paragraph 22B should contain an additional point as follows: “the directors' statement that they have carried out a robust assessment of the principal risks facing the company, including those that would threaten solvency or liquidity, and the annual report disclosures that address how those risks being managed or mitigated, omit a material solvency or liquidity risk.” The end of paragraph 22B would then explain that, if this risk was missing, the auditor should include that risk in their report. This would achieve the FRC's objective without adding significantly to the length of the auditor's report.

We agree with the proposed changes to ISAs (UK and Ireland) 260 and 570, subject to any changes to paragraph 17-2 of ISA (UK and Ireland) 570 as a result of our suggested changes to ISA (UK and Ireland) 700.

We have three final observations:

- If paragraph 22C remains broadly in the proposed form, it is unclear whether this is a “report by exception” duty under paragraph 22 and/or 22A or not. As explained above, we believe our alternative suggestions would achieve the same ends whilst providing clearer communication to readers of the audit report.
- The FRC’s Bulletins 2006/5, 2009/4 and 2011/1 deal with the auditor’s existing “review” responsibilities in respect of corporate governance and the going concern statement required both by the UK and Irish listing rules. The material in these bulletins is now significantly out of date, and will become even more so in light of the FRC’s proposals. Many of the provisions subject to review overlap with specific duties of the auditor introduced as part of the revisions made to auditing standards in 2012 and 2013 as part of the Effective Company Stewardship project.
 - We suggest that as part of the FRC’s discussions with the FCA and the Irish Stock Exchange about proposed changes to their listing rules, consideration should be given to either removing or updating the review requirements in FCA LR 9.8.10R and ISE LR 6.8.6.
 - If they are to be updated (rather than removed), a revised Bulletin should be prepared which clearly sets out the scope of the required review.
- The FRC should also consider whether to update or withdraw APB Bulletins 2008/1 and 2008/10. Bulletin 2008/1 was written at a particular point in time and more generic messages may now be more appropriate. Bulletin 2008/10 was written in the context of the FRC’s 2008 guidance on going concern and is also consistent with the guidance issued in 2009. It would require some revision to be consistent with the proposed Guidance. It would be helpful if any revised bulletin was ready in sufficient time to be used in planning audits to which the proposed Guidance applies and covered the FRC’s planned changes to going concern for other entities.

Question 9 – in relation to the proposed changes to the UK Corporate Governance Code

The FRC would welcome views on whether the additions [to Sections C.1 and C.2 of the Code] 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.

We agree with the new Code Provision C.2.1.

We understand why the FRC is proposing that Code Provision C.1.3 should be removed in order to reduce the confusion between “being a going concern” and “adopting the going concern basis of accounting”. However, one of the effects of this Provision was that boards considered a detailed paper on going concern before reaching their conclusion for the annual report. We believe that this practice should continue and suggest that the FRC includes a reminder in the final guidance.

Given the removal of the “plain language” statement on going concern, we believe it is imperative that directors draft their discussion around the liquidity impact of principal risks with particular care and attention, to avoid any implication that the company may not be a going concern as defined in IAS 1.

We agree with the proposed wording amendments to bring the Code in line with the Companies Act.

Appendix 2: Worked example of questions from Appendix D and Appendix E

In our response to question 4 we suggest that Appendices D and E could usefully be integrated to make them more accessible and scalable. We have set out below an example of how this might be done.

Is the board satisfied that it can effectively exercise its responsibilities to manage the company's risk?

- Does the board have the skills, knowledge, experience and support necessary to understand and assess the risks facing the company? Does this involve sufficient breadth of experience and expertise in each committee? (D & E)
- 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 board papers and processes support the board in exercising its risk responsibilities? (D & E)
- Is there clarity on which board committee is responsible for ensuring that reward schemes reflect the company's approach to risk? (E)
- Do non-executive directors have enough time, access and support to understand the business and its people in enough depth? (E)

(D) and (E) in brackets indicates the source of each question.