Quoted Companies Alliance

6 Kinghorn Street
London EC1A 7HW

T +44 (0)20 7600 3745
F +44 (0)20 7600 8288
mail@theqca.com

www.theqca.com

Catherine Woods
Financial Reporting Council
Fifth Floor
Aldwych House
71-91 Aldwych
London WC2B 4HN

riskreview@frc.org.uk

24 January 2014

Dear Ms Woods,

Financial Reporting Council – Risk Management, Internal Control and the Going Concern Basis of Accounting - Consultation Document

Introduction

We are the Quoted Companies Alliance, the independent membership organisation that champions the interests of small to mid-size quoted companies. Their individual market capitalisations tend to be below £500m.

The Quoted Companies Alliance is a founder member of EuropeanIssuers, which represents over 9,000 quoted companies in fourteen European countries.

The Quoted Companies Alliance Corporate Governance and Financial Reporting Expert Groups have examined your proposals and advised on this response. A list of members of the Expert Groups is summarised in Appendix A.

Response

We welcome the opportunity to respond to this consultation and note that, as set out in the introduction to the consultation document, the intended audience for the guidance is companies that apply the UK Corporate Governance Code ('the Code'), either because they are required to or choose to do so voluntarily. We understand that the Financial Reporting Council (FRC) is preparing separate, simpler guidance for other companies. Most of our members will fall into the voluntary or other company category, as they seek to meet the key elements of the Code and follow best practice in this important area.

In providing a response to the Consultation we have initially set out our views on the overall draft revised guidance and then considered each question posed by the FRC.

Overview of draft revised guidance

(a) Risk Management and Internal Control

Background

We agree that the guidance on risk management and internal control requires refreshing given the last full review was in 2005. Whilst, the approach to risk management and internal control has not changed a great deal in terms of basic methodology since the last review, certain key concepts and techniques have been developed and redefined and we have experienced a major economic downturn. Furthermore, the general business environment has also become more complex and faster moving, and companies have had to respond to this and have become more mature in their response.

Consequently, the corporate risk profile has changed, and with it there is a greater expectation on the board and management to demonstrate sound risk and control activities as part of good governance. The key outcomes should be that risk management and internal control activities are embedded in the organisation (an essential tenant of the current guidance) and that this should lead to an annual report and accounts that provides confidence to shareholders that the principal risks have been identified, and are being appropriately managed to generate profit, whilst ensuring that the business remains a going concern.

Presentation

We believe that the draft revised guidance in both structure and detail has become denser in terms of text presentation and there is a lack of sign-posting throughout the document, especially given the size of the document has nearly doubled (now 59 paragraphs from the current 38). The guidance would benefit from being shorter with better use of sub-headings, tables and other techniques that lead the reader through the concepts and make it clearer for directors. For example, in the current guidance, the Introduction promotes the 'importance of internal controls and risk management' and 'the objectives of the guidance'. The length, detail and need for the appendices also require further review (see later comments).

The guidance uses the terms "required by the provisions of the UK Code. However, since "comply or explain" applies to the UK Code provisions, the guidance should not be encouraging companies to treat the provisions of the UK Code as rules that companies are "required" to apply (see para 41 "as required by the Code")

Responsibility for risk

We agree that the FRC is right to consider the board's responsibility in more depth and also to provide more guidance on communication and reporting. However, there is a lot of attention to broad statements of good practice and, given the nature of the area, it would be useful to set out the actual framework that provides the foundation of the guidance. Reference could also be made to the methodologies and practices promoted in other recognised standards, such as the International Risk Standard ISO 31000.

A key element of responsibility for risk relates to board sponsorship and leadership. Whilst section 3 of the revised guidance refers to 'company's leadership and management', the board needs to demonstrate leadership and, given things get done if individuals take ownership, organisations that are successful in making risk work tend to have someone at board level with a designated overall responsibility for the area. There is also a continued focus on the simple and persuasive concept of the *'3 Lines of Defence',* which clearly defines the roles of: (1) the board, management and employees; (2) the audit (and risk) committee and where appropriate risk managers; and (3) independent assurance providers.

Risk management concepts

The revised guidance emphasises the culture in the organisation and there is a lot of focus on the front end identification process, together with the traditional perception that risk is a 'threat'. There is mention of 'opportunity' risk. However, this is not very well explained, given this is one of the main areas that companies now need to consider as this could be one of the highest risks in not achieving strategic objectives.

Whilst not seeking to increase the length of the guidance, other areas that merit further amplification include:

- Setting out a clearer model for risk management and internal control, the current draft includes a lot of broad statements;
- The need to define and explain some key terms such as the base-level terms: 'risk', 'risk management', 'internal control', and concepts that are now integral to most systems such as: 'risk appetite';
- The use of different identification sources to ensure a comprehensive view, especially given the broader range of threats and opportunities Promoting the determination of inherent vs. residual risk (a key point raised in the FRC's 'Boards and Risk' paper);
- The importance and range of control activities – linking risks to controls and being able to determine the effectiveness of controls tends to be a weak area for a lot of companies – whatever size'; and
- The need for on-going monitoring – it is included, but does not have a prominent position.

Further specific details are set out in the answers to the 9 questions posed in the Consultation Paper (see the section following (b) below).

(b) Going Concern Basis of Accounting

Background

We agree that it is logical to link the guidance on assessing the appropriateness of using the going concern basis to the guidance on risk management. This reflects the principles outlined in the Sharman report and the interaction between the disclosure in the annual report of principal risks and material going concern uncertainties. However, we do have some specific concerns as outlined below.

Presentation

In combining the going concern guidance and risk management documents, a lot of the detail of the 2009 going concern guidance has been lost. We are concerned that this may be seen as a change of emphasis by the FRC, downgrading the importance of assessing going concern. Equally, financial risks are often perceived to be well managed, with structured controls in place and attention paid to managing those risks. Hence, residual risk is often seen as low and companies may not accord going concern the amount of forward-looking attention that it requires under the new proposals. This may also make things more difficult for the auditor, as companies may not produce a sufficiently detailed going concern assessment and there may initially be a lack of consistency.

Need for practical guidance

The consultation document also offers less practical assistance in assessing going concern. Examples of matters in the 2009 guidance that directors found helpful are the illustrative disclosures in the appendix and the sections dealing with confirmations from lenders, groups and auditor considerations.

The 2009 guidance made repeated use of the word "proportionate", particularly in the context of "balanced, proportionate and clear disclosures". Although the concept is not entirely absent from the consultation document, it is not as clearly expressed, with the word "proportionate" not featuring at all. Given standard setters' and the FRC's current focus on cutting clutter and providing relevant disclosures, we would like to see this concept more clearly articulated and the reintroduction of the word "proportionate". This is particularly relevant to the small and mid-size quoted companies that constitute our membership.

Provision C.1.3 (on the going concern statement)

We do not agree that the existing provision C.1.3, requiring a positive statement that the company is a going concern, should be removed. Whilst we understand that the FRC is trying to reduce any chance of duplicate disclosure, we view the replacement proposed in the consultation paper to be a weaker statement than confirming positively that the company is a going concern. We discuss this in more detail in our response to Question 9 below.

Specific questions in the consultation paper

Below are some specific comments on the issues on which views are sought:

1. The FRC considers Sections 5 and 6 of the draft revised guidance, which replace Sections 2 and 3 of the current guidance, remain fit for purpose – Do you agree or are more substantive changes to these sections required?

In overall terms, we agree that these sections remain 'fit for purpose' and cover the key aspects in the guidance narrative. However, the key areas of linking risks to controls and assessing individual risks in order to prioritise and establish the principal risks are not very well defined.

In the current guidance in paragraphs 22 and 23, it notes that: "A system of internal control cannot totally eliminate the possibility of poor judgement, human error, management override and the occurrence of other unforeseeable circumstances". This is not included in the revised guidance. However, we believe that it still is a relevant issue for most companies regardless of size, as sound systems of risk management and internal control provide reasonable, but not absolute, assurance.

The review of the effectiveness of risk management and internal control (Section 6) tends to rely on management undertaking some form of self-assessment as well as coordinating a range of assurance providers. This is an essential role of internal audit and increasingly larger corporate organisations put in place either an in-house or outsourced capability, depending on the risk profile and the assurance needs defined by the board or audit committee.

A further source of information can be provided by monitoring and understanding any incidents or loss events, as these may indicate trends of system or control failure.

2. The proposed change to the current guidance in relation to significant failings or weaknesses identified during the review.

We agree that this is a positive step as it represents an area that needs greater transparency. The recent Grant Thornton Corporate Governance Review 2013 indicated that this is an area that requires further attention, as companies tend to be reluctant to disclose information that they consider may put them at some competitive disadvantage. However, they need to balance this with the need for the annual report and accounts to give sufficient information to reassure shareholders that their risk management and internal control framework is effective, with appropriate measures in place to identify and address failings.

As set out in the consultation paper, the guidance should be more explicit in this area in order to try to counter companies reverting to “boilerplate” responses. However, we also believe that there also needs to be some form of review and feedback mechanism on what is being presented, which should be reviewed and monitored by the FRC.

3. Are the appendices A-E of use to directors and how might they be improved?

The appendices effectively double the size of the guidance and, as previously noted, are not well sign-posted in the main text. Whilst they provide a lot more detail, the challenge is whether this is needed in certain areas, if important certain information should be included in the guidance itself. A summary by appendix is set out below.

Appendix A: The summary of the UK Corporate Governance Code and Regulatory Requirements is an essential point of reference and brings together the key constituents.

Appendix B: See our response to question 4.

Appendix C: See our response to question 5.

Appendix D: This is a useful aid memoire, but there should be more linkage to the main guidance - the headings consider more of the ‘front-end’ risk process with less emphasis on the control effectiveness side.

Appendix E: Whilst this appendix provides some broad areas to consider, the need for such an appendix is unclear and some of the points made require amplification for example – ‘Significant regulatory problems’ and ‘Mechanical and static processes’.

4. Is the approach taken in appendix B (Assessing Solvency and Liquidity Risks) of the draft revised guidance appropriate?

Overall we support the approach taken in Appendix B.

We agree that using “going concern” only with its accounting standards meaning is much clearer than the approach taken in the January consultation paper (although the expression is still used in Appendix B (third paragraph under “Solvency and liquidity risks”)). Although this usage is in the context of past assessments, we think this still risks causing confusion.

We also agree that the term “a high level of confidence” should only be used in the context of severe distress (as it is in Appendix C). We do not, therefore, understand its use in Appendix B (second paragraph under "Considering what information is available about the future"), which states: "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."

5. Do you agree with the guidance in appendix C (Determining and Reporting on the Going Concern Basis of Accounting) - if not how should it be amended and why?

We agree with the overall approach taken in Appendix C (however, see our comments above regarding the level of guidance given).

However, we are concerned that, as this is the only section of the consultation document that explicitly mentions "going concern" in its title, it will be treated as a standalone appendix by readers seeking guidance on going concern. his would negate the benefits of integrating the risk assessment and going concern guidance and make the content of the appendix potentially confusing (the concept of "severe distress", for example, is given no introduction or context in this appendix as it relies on having already read Appendix B).

Therefore, we think that Appendix C should succinctly repeat, perhaps in an introduction, the revised approach to assessing going concern as part of a wider risk assessment and make clear that it is not a standalone appendix.

6. Do you agree with the revised guidance to directors of banks – if not what needs to be amended and why?

We agree that banks, and indeed other financial institutions, have a different risk profile and in the context of the going concern statement and related disclosure merit separate guidance to deal with issues that are more relevant to their business model. However, the term 'banks' should be defined at the outset as there are many financial organisations that now operate as a bank. The Preface to the document should also define the 'intended audience' and that there will be the separate, simpler guidance that will be provided for other companies.

7. Do you agree with the revised guidance to auditing standards – if not what should be changed and why?

We agree with the revised guidance, in particular the change in wording which only requires the auditor to report if they have "anything *material*" to add.

However, we would reiterate the view previously expressed that the FRC should make changes by influencing the IAASB's auditing standards rather than making unilateral changes to the UK and Ireland version. The latter cause's unnecessary duplication of effort for both the FRC and its constituents when the IAASB subsequently decides to make changes and a second consultation exercise has to be held.

8. Should changes be made to the Code to facilitate the integration of the assessment of, and reporting on, the going concern basis of accounting, with the assessment of, and reporting on, its principal risks?

We agree that changes should be made to the Code to help facilitate and explain the new guidance. Further details are set out in our response to question 9 below.

9. Are the additions to Sections C.1 and C.2 of the Code required, including the detailed wording, and should the existing Provision C.1.3 (on the going concern statement) be removed?

We agree that the new provisions should be added. A further enhancement to provision 2.2 would be to emphasise that the board should monitor the company's risk management and internal control on a <u>regular basis, and at least annually carry out an effectiveness review.</u>

We do not agree that the existing provision C.1.3, requiring a positive statement that the company is a going concern, should be removed. The replacement requirement for the directors to confirm that they have assessed the principal risks is much weaker. Although accounting standards require the use of the going concern basis unless it is not appropriate, there is no requirement to state that such a basis has been used. This risks making financial statements less clear.

Conclusion

If you would like to discuss any of these issues further, we would be happy to attend a meeting.

Yours sincerely,

Tim Ward
Chief Executive

APPENDIX A

Quoted Companies Alliance Corporate Governance Expert Group

Edward Craft (Chairman)	Wedlake Bell LLP
Colin Jones (Deputy Chairman)	UHY Hacker Young
Victoria Barron	Hermes Equity Ownership Services
Edward Beale	Western Selection Plc
Rob Burdett	FIT Remuneration Consultants
Anthony Carey	Mazars LLP
Richie Clark	Fox Williams LLP
Louis Cooper	Crowe Clark Whitehill LLP
Madeleine Cordes	TMF Corporate Secretarial Services Ltd
Kate Elsdon	PricewaterhouseCoopers LLP
David Firth	Penna Consulting PLC
Peter Fitzwilliam	Mission Marketing Group (The) PLC
David Fuller	CLS Holdings PLC
Clive Garston	DAC Beachcroft LLP
Nick Graves	Burges Salmon
Andrew Hobbs	EY
Alexandra Hockenhull	Xchanging plc
David Isherwood	BDO LLP
Nick Janmohamed	Speechly Bircham LLP
Dalia Joseph	Oriel Securities Limited
Claire Noyce	Hybridan LLP
Gabriella Olson-Welsh	McguireWoods
Anita Skipper	Aviva Investors
Julie Stanbrook	Hogan Lovells International LLP
Nicholas Stretch	CMS Cameron McKenna LLP
Peter Swabey	ICSA
Eugenia Unanyants-Jackson	F&C Investments
Melanie Wadsworth	Faegre Baker Daniels LLP
Cliff Weight	MM & K Limited

Quoted Companies Alliance Financial Reporting Expert Group

Matthew Stallabrass (Chairman)	Crowe Clark Whitehill LLP
Joseph Archer	Crowe Clark Whitehill LLP
Edward Beale	Western Selection Plc
Anthony Carey	Mazars LLP
Jack Easton	UHY Hacker Young
David Gray	DHG Management
Matthew Howells	Smith & Williamson Limited
Shalini Kashyap	EY
Niraj Patel	Saffery Champness
Nigel Smethers	One Media IP Group plc
Chris Smith/Andy Ka	Grant Thornton UK LLP
Ian Smith/Bill Farren	Deloitte LLP
Paul Watts/Jonathan Lowe/ Nick Winters	Baker Tilly