

April 2014

Proposed Revisions to the UK Corporate Governance Code

Consultation Document

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

The FRC does not accept any liability to any party for any loss, damage or costs howsoever arising, whether directly or indirectly, whether in contract, tort or otherwise from any action or decision taken (or not taken) as a result of any person relying on or otherwise using this document or arising from any omission from it.

© The Financial Reporting Council Limited 2014

The Financial Reporting Council Limited is a company limited by guarantee. Registered in England number 2486368. Registered Office: 5th Floor, Aldwych House, 71-91 Aldwych, London WC2B 4HN.

Contents

Section 1: Introduction / How to respond	2
Section 2: Remuneration	5
Section 3: Risk management and going concern	9
Section 4: Audit committees and audit tendering	15
Section 5: Location of the corporate governance disclosures	16
Appendix A – Draft revised UK Corporate Governance Code [Sections C, D & E and Schedule A]	17
Appendix B – Draft extracts from risk and going concern guidance	27

SECTION 1: INTRODUCTION

The FRC is consulting on proposed changes to the UK Corporate Governance Code which, if implemented, will apply to reporting years beginning on or after 1 October 2014.

This consultation follows earlier consultations on directors' remuneration (October 2013) and risk management, internal control and the going concern basis of accounting (November 2013). As a result of those consultations, the FRC is proposing that:

- greater emphasis be placed on ensuring that remuneration policies are designed with the long-term success of the company in mind, and that the lead responsibility for doing so rests with the remuneration committee;
- companies should put in place arrangements that will enable them to recover or withhold variable pay when appropriate to do so, and should consider appropriate vesting and holding periods for deferred remuneration;
- companies should explain when publishing AGM results how they intend to engage with shareholders when a significant percentage of them have voted against any resolution;
- the schedule to the Code dealing with the design of performance-related remuneration for executive directors is updated to encourage companies to give further consideration to the arrangements they have in place for deferred remuneration, such as vesting and holding periods for shares;
- companies should state in their financial statements whether they consider it appropriate to adopt the going concern basis of accounting and identify any material uncertainties to their ability to continue to do so;
- companies should robustly assess their principal risks and explain how they are being managed and mitigated;
- companies should state whether they believe they will be able to continue in operation and meet their liabilities taking account of their current position and principal risks, and specify the period covered by this statement and why they consider it appropriate; and
- companies should monitor their 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 reasons for these proposals are explained in Sections 2 and 3 of this paper, with the proposed changes shown in Appendix A.

The FRC is also consulting on extracts from its proposed merged guidance on risk and going concern which is intended to help companies to apply the proposed revised Code. These are explained in Section 3 and contained in Appendix B. The full guidance will be published at the same time as the revised Code.

Following the decision of the Competition Commission (now the Competition and Markets Authority) to delay finalising its proposed Orders to implement the findings of its review of competition in the market for audit services in FTSE 350 companies, the FRC has decided to defer consideration of whether to make any changes to the section of the Code dealing with the audit committee and appointment of the external auditor until the Code is next reviewed; currently scheduled to be in 2016. The reason for this decision is explained in Section 4.

Finally, Section 5 seeks views on whether there would be benefits in allowing companies to publish some or all of the information currently contained in the corporate governance report on a website rather than in the annual report and accounts. If it is felt that this would be beneficial, any resulting proposals would also be considered as part of the review scheduled for 2016.

Financial Reporting Council
24 April 2014

HOW TO RESPOND

Comments on the questions set out in this consultation document are requested by 27 June 2014. Responses should be sent by email to codereview@frc.org.uk.

or in writing to:

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

Please note that the FRC will be moving offices in mid-June. While responses sent in writing after it has moved will be forwarded, it is advisable to send your response electronically as well. All responses will be acknowledged.

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

SECTION 2: DIRECTORS' REMUNERATION

In October 2013 the FRC published a consultation paper entitled 'Directors' Remuneration' in which it sought views on three specific issues:

- whether to introduce in the Code a “comply or explain” presumption that companies would have in place arrangements enabling them to withhold or retrieve variable pay when considered appropriate (“clawback” arrangements);
- whether to recommend in the Code that companies should consult with shareholders where a significant minority had voted against a resolution on remuneration, and to report to the market on the outcome of those discussions; and
- whether to recommend that non-executive directors who were also executive directors in other companies should not sit on the remuneration committee.

The FRC received 64 responses to the consultation. Of these, 22 were from listed companies, ten from institutional investors, ten from service providers or consultants, and 17 from representative bodies. The remainder came from individuals and miscellaneous bodies.¹

In the October 2013 consultation paper, the FRC also sought views on whether more extensive revisions to the remuneration sections of the Code were required. The strong view of most respondents was that this was not desirable at this time, and that the FRC would be better advised to wait until it was better able to assess the impact of the Government's recent changes to voting and reporting on directors' remuneration.² For this reason, the FRC is proposing only limited changes to the detailed provisions of the Code. These are set out below, and Appendix A contains the complete Sections D and E and Schedule A of the Code with the proposed changes shown.

The FRC is proposing to amend the high-level Principles in Section D of the Code, which deals with remuneration. While the FRC considers that it has always been clear in the Code that remuneration policies must be designed to deliver long-term benefit to the company rather than short-term benefit to management, it accepts that some of the wording in the Code – for example, on the need to be able to “attract, retain and motivate” directors and on consultation with the chief executive – may be capable of being read otherwise. The proposed changes are intended to remove any doubt as to the intention.

Specifically, the FRC proposes that the current Principle D.1 – “Levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully, but a company should avoid paying more than is necessary for this purpose. A significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance” – should be replaced with:

“Executive directors' remuneration should be designed to promote the long-term success of the company. Performance-related elements should be stretching and rigorously applied.”

¹ Copies of all responses, with the exception of those that respondents asked to be kept confidential, are available on the [FRC website](#).

² New requirements related to voting on remuneration policies have been enacted in the Enterprise and Regulatory Reform Act 2013. Details of the information companies must disclose in their remuneration reports are set out in the Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013.

The FRC believes that the current Principle D.2 – “There should be a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in deciding his or her own remuneration” – remains fit for purpose. However, it proposes to revise the Supporting Principle to read:

“The remuneration committee should take care to recognise and manage conflicts of interest when receiving views from executive directors or senior management, or consulting the chief executive about its proposals. The committee should be responsible for appointing any consultants in respect of executive director remuneration.”

Question 1: Do you agree with the proposed changes in Section D of the Code?

Clawback Arrangements

In the October 2013 consultation paper, the FRC sought views on whether there should be a “comply or explain” presumption in the Code that companies establish arrangements to withhold or retrieve variable pay where appropriate.

This proposal received strong support from investors. Companies, while not questioning the value of such arrangements, were less convinced there was a need for revision to the Code, arguing that the requirement in the Regulations to disclose the availability and use of such arrangements would result in the majority of companies introducing them, where they were not already in place.

Notwithstanding these reservations, the FRC proposes to make an addition to the Code. The proposed addition will use the same terminology as the Regulations to avoid any potential confusion. However, the FRC does not propose to specify in detail how these arrangements should operate or the specific circumstances in which they should be applied. Best practice is evolving rapidly and the FRC would not want the Code inadvertently to constrain how it develops.

The FRC proposes to amend Provision D.1.1 of the Code as follows (the proposed new wording is underlined):

“D.1.1. In designing schemes of performance-related remuneration for executive directors, the remuneration committee should follow the provisions in Schedule A to this Code. Schemes should include provisions that would enable the company to recover sums paid or withhold the payment of any sum, and specify the circumstances in which the committee considers it would be appropriate to do so.”

In view of the desire not to specify the circumstances in which clawback arrangements might apply, the FRC proposes to delete from Schedule A the statement that “Consideration should be given to the use of provisions that permit the company to reclaim variable components in exceptional circumstances of misstatement or misconduct”.

Question 2: Do you agree with the proposed changes relating to clawback arrangements?

Votes Against Remuneration Resolutions

The FRC sought views on whether the Code should set out a specific process to be followed by companies in circumstances where there had been a significant percentage of votes against a remuneration resolution at the AGM.

Companies that commented noted that the Regulations contained new disclosure requirements in relation to the outcome of remuneration resolutions, and that the guidance on the Regulations produced by the GC100 and Investor Group³ suggested further disclosure on the issue. The majority of companies considered that the FRC should wait and assess the impact of the Regulations and guidance before proposing further processes.

Investors views were more mixed. Some agreed with companies that the reporting requirements in the Regulations should be sufficient to ensure that companies would engage with shareholders where there were clear concerns, but others felt it would be helpful to give further prompting to companies through the Code.

In addition, a concern was expressed by some respondents that singling out remuneration resolutions for special attention in the Code might send a signal that – by comparison – engagement on strategy, board composition and other matters of significance to shareholders were not a priority. This is a concern that the FRC shares. This is not in any way to understate the importance of proper engagement on remuneration issues, simply to note that it should take place in addition to, and not at the expense of, engagement on other issues.

The FRC is therefore attracted to a suggestion put forward by the National Association of Pension Funds and the Association of British Insurers that a recommendation should be added to the Code, covering all resolutions not just those relating to remuneration, to the effect that companies should give a clear signal when publishing the results of the AGM that they will initiate engagement with shareholders on any issue on which there has been a significant minority vote against. It was considered that this would give shareholders a sufficient hook to ensure that engagement took place on the subject matter of resolutions on which shareholders had expressed concerns.

The FRC is therefore proposing to add the following provision to Section E.2 of the Code, which deals with the constructive use of the AGM:

“When, in the opinion of the board, a significant proportion of shareholders have voted against a resolution at any general meeting, the company should explain when announcing the results of voting what actions it intends to take to understand the reasons behind the vote result.”

The FRC’s intention is that companies should set out how they intend to go about engaging with shareholders in order to assess their concerns, rather than setting out how they intend to respond to those concerns (which the FRC accepts could not realistically be done so soon after the AGM).

Question 3: Do you agree with the proposed change relating to AGM results? Is the intention of the proposed wording sufficiently clear?

Remuneration Committee Membership

There was virtually no support from respondents to the earlier consultation paper for a recommendation against executive directors serving as non-executive members of a remuneration committee of another listed company. The data shows no correlation between the presence or otherwise of such an individual and historic levels of dissent on remuneration resolutions. As a result, the FRC does not intend to take this proposal any further.

³ *The Directors’ Remuneration Reporting Guidance* was published in September 2013.

Investors who commented stated that what mattered to them was that there was an appropriate balance of views and experience on the remuneration committee and a robust process in place to ensure that it undertook its role objectively and independently. Where these conditions were met, they considered that the knowledge of the current environment that a serving executive director could contribute might at times be beneficial. Where they were not met, investors considered that a combination of the increased information and enhanced voting rights provided by recent legislation and the annual election of directors, introduced through the Code in 2010 and now adopted by all but two per cent of FTSE 350 companies, gave them the ability effectively to ensure their concerns were addressed.

While not supporting the specific proposal, investors considered that companies could do more to explain why individual directors are the most appropriate persons to serve on their boards and committees and what skills and experience they bring. The FRC shares this view, as was highlighted in 'Developments in Corporate Governance 2013', the FRC's most recent annual report on the implementation of the Corporate Governance and Stewardship Codes, published in December 2013. It is important that companies are willing and able to justify why individuals have been chosen to serve on the board and committees and why they believe that collectively they bring an appropriate degree of challenge and diversity to the decision-making process. The FRC will continue to monitor the quality of companies' reporting on this issue.

The FRC also announced in December that it would undertake work during 2014 to identify good practice in succession planning and the process by which directors are appointed. It believes that more widespread adoption of good practice could also help to improve the balance and diversity of boards and committees.

Other proposed amendments

The FRC is proposing a number of changes to Schedule A ('The design of performance-related remuneration for executive directors') which were not included in the earlier consultation paper but which the FRC believes are consistent with the desire to ensure that remuneration policies encourage directors to work for the long-term success of the company.

The purpose of the proposals is to encourage companies to give further consideration to the arrangements they have in place for deferred remuneration, such as vesting and holding periods for shares. In part the changes are intended to sharpen up existing references, but a proposed addition is that companies should consider requiring directors to continue to hold at least some shares for a period after leaving the company. Investors appear to be generally supportive of this practice, and anecdotal evidence suggests that it is increasingly reflected in companies' share ownership guidelines.

Question 4: Do you agree with the proposed amendments to the Schedule?

The FRC has decided not to remove from the Code the requirement to disclose the use of remuneration consultants and whether they have any other links with the company (Provision D.2.1), even though this is now addressed in more detail in the Regulations. This is because, as applying the Code is a Listing Rules rather than a company law requirement, it extends to overseas companies with a Premium listing. The FRC believes it is important that these companies should be expected to uphold the same standards as UK registered listed companies.

SECTION 3: RISK MANAGEMENT AND GOING CONCERN

In November 2013 the FRC published a consultation paper entitled 'Risk Management, Internal Control and the Going Concern Basis of Accounting', in which it sought views on both proposed changes to the Code and related draft guidance on risk management and going concern.

The FRC received 54 responses to the consultation. Of these, five were from listed companies, six from institutional investors, seven from auditing firms, two from service providers or consultants, 11 from risk managers, four from individuals and 19 from representative bodies.⁴

This consultation now focuses on proposed amendments to the Code which, as explained below, differ from those on which the FRC previously consulted and reflect feedback from respondents to that prior consultation. It also seeks views on revised versions of those sections of the guidance that describe how the proposed changes to the Code should be applied – primarily in relation to the various disclosures that companies would be asked to make if the proposals were adopted – which it is hoped will help readers better to understand the intended impact of the proposed changes.

The FRC does not intend to re-consult on the guidance as a whole. Although a considerable number of detailed comments were received, the overall view of respondents was that the structure, content and level of detail of the draft guidance was broadly right. While it will not be possible to finalise the guidance until the Code itself has been finalised, the content of many of the sections of the draft guidance – for example, those dealing with the responsibilities of the board, the issues that boards need to consider in exercising those responsibilities, and the design of the risk management and internal control system – are not dependent on the content of the Code. The FRC will revise them in parallel with this consultation, and the revised guidance will be issued alongside the revised Code.

Proposed revisions to the Code

There were three elements to the proposed changes to the Code on which the FRC consulted in November 2013:

- that companies should robustly assess their principal risks and report on how those risks were being managed or mitigated;
- clarification that boards have a responsibility to monitor the risk management and internal control systems on an ongoing basis, and not rely solely on an annual review; and
- to establish the appropriate relationship between the board's risk assessment and management responsibilities and its assessment of the company's future viability and its ability to continue to adopt the going concern basis of accounting, and how these matters should be reported.

The FRC proposes to adopt the first two changes as set out in the earlier consultation. The revised approach to assessing and reporting on the company's future viability is significantly different from that put forward in the earlier consultation, and is explained in more detail below. The full proposed revisions are shown in Appendix A.

⁴ Copies of all responses, with the exception of those that respondents asked to be kept confidential, are available on the [FRC website](#).

Principal risks and monitoring the risk management system

A few respondents queried the proposal to change the wording of Principle C.2 – which currently reads “the board is responsible for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives” – so that it refers to “principal risks” rather than “significant risks”. It was suggested this might be interpreted as requiring a different degree of diligence on the part of the board. As explained in the earlier consultation document, the reason for proposing the change is simply to make the wording of the Code consistent with that of the Strategic Report,⁵ and should not be seen as implying a different standard. The FRC considers that the words “principal” and “significant” are interchangeable for the purposes of applying the Code.

While most respondents supported an explicit reference to describing how principal risks are managed or mitigated, some were concerned that doing so might create difficulties for those companies registered with the Securities and Exchange Commission in the USA. The FRC takes the view that this is not an argument against improving reporting standards in the UK, and notes that it is already increasingly common for larger listed companies, including some SEC registrants, to discuss how they attempt to manage or mitigate their risks in the annual report. The FRC also notes that under new EU requirements on non-financial reporting,⁶ which were agreed in April 2014, companies will be required to report on “the principal risks related to those matters linked to the undertaking’s operations... and how the undertaking manages those risks”. In the FRC’s view, the proposed Code changes therefore reflect existing good practice and are consistent with future regulatory requirements.

The revised wording relating to the board’s ongoing responsibility for monitoring the risk management and internal control system in the earlier consultation draft was generally considered to be uncontroversial, and a useful clarification of the intent underlying the current wording of the Code. The FRC therefore proposes to proceed with that change.

Question 5: Do you agree with the changes to the Code relating to principal risks and monitoring the risk management system?

Future viability and going concern

The FRC originally consulted on how best to implement Lord Sharman’s proposals on going concern⁷ in January 2013. Feedback on the FRC’s original proposals raised a number of concerns, in particular that:

- using the phrase “going concern” to describe both the specific assessment required when preparing the financial statements, and the broader assessment of the risks affecting a company’s viability, created confusion and might result in misaligned expectations of what degree of assurance was provided when companies stated that “the business is a going concern”, as required under existing Code Provision C.1.3; and
- the suggestion that, when reporting on the broader assessment of the company’s viability, boards should state that they have a “high level of confidence” for the “foreseeable future” was read by many respondents as implying an unrealistic expectation that there should be no limit to the period of, or degree of certainty associated with, the assessment.

⁵ Section 414C(2)(b) of the Companies Act 2006, requires a company to disclose its “principal risks and uncertainties” as part of its Strategic Report.

⁶ Article 19A(1)(d) Directive 2013/34/EU.

⁷ The reports of the Sharman Panel Inquiry into going concern and liquidity risks can be found on the [FRC website](#).

In November 2013 the FRC put forward for consultation a different approach, with the aim of:

- making a clearer distinction between the meaning of going concern in the broad context meant by Lord Sharman and how it was used in accounting standards, by reserving the term “going concern” for the accounting purpose, and
- making a clearer link between the assessment of risks to the viability of the business (in particular, solvency and liquidity risks) and the broader risk assessment that should form part of a company’s normal risk management and reporting processes, as recommended by Lord Sharman.

An important part of that approach was the proposal to integrate the FRC’s separate guidance notes on going concern and on risk management and internal control in a single piece of guidance, and to expand the scope of the current guidance on risk to cover the board’s full range of responsibilities, not just those relating to the design and oversight of the internal control system, as had previously been the case. As noted, this has been broadly welcomed and the FRC will publish final integrated guidance at the same time as the revised Code.

In the Code itself, the FRC proposed deleting the provision requiring a going concern statement (Code Principle C.1.3), arguing that it would be sufficient to rely on the existing requirements in international accounting standards and the FCA’s Disclosure and Transparency Rules to ensure that the “narrow” assessment for accounting purposes was carried out and reported on. The FRC also proposed to link that assessment with the broader assessment of risks to the viability of the company by making it clear that the principal risks disclosed by companies should include the principal solvency and liquidity risks, and that the company should indicate which if any of these risks were also considered “material uncertainties” for the purposes of the assessment required by accounting standards. The FRC suggested that this would amount to an implicit statement on the company’s viability.

This proposed approach was broadly supported by companies. Investors, however, argued strongly that boards should make an explicit statement of some sort on their broader assessment of the company’s ongoing viability. They and some other respondents also argued that, even if the reference to “going concern” in the current Code Provision C.1.3 were to be interpreted as having the meaning set out in accounting standards, there was value in retaining that provision as it would encourage boards to pay due attention to the matter.

In the light of this feedback, the FRC has considered whether it would be appropriate to ask companies to make separate statements covering the narrow and broad assessments, and to do so in a way that achieved the aims set out above while avoiding the concerns raised by the January 2013 proposals.

The FRC is therefore seeking views on whether to:

- retain existing Code Provision C.1.3 but amend the wording to clarify that it refers to the assessment of going concern for accounting purposes. The suggested wording is: “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”; and

- add a new Provision C.2.2 to introduce a requirement to make an explicit statement on the board's broader assessment of the company's ongoing viability. The suggested wording of the new provision is:

"The directors should state whether, taking account of the company's current position and principal risks, they have a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due, drawing attention to any qualifications or assumptions as necessary. They should indicate the period covered by this statement, and why they consider that period to be appropriate".

The proposed wording attempts to deal with the matters to be considered when making the assessment, the time horizon that it covers, and the degree of certainty that can be attached to it in a way that would encourage companies to provide meaningful disclosure tailored to the specific circumstances of the company rather than producing standardised or heavily qualified statements. It aims to do so by specifying that:

- the statement should be based on the board's assessment of the company's current position as well as its assessment of the principal risks facing the company and their potential impact on its future development and prospects. The FRC proposes to use the word "position" as the starting point for this assessment in order to be consistent with Principle C.1 of the Code (which states that "the board should present a fair, balanced and understandable assessment of the company's position and prospects")⁸ and the requirement to include in the Strategic Report information on "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 last year";
- the period of time to be covered by the statement must be a matter for the board's professional judgement, taking into account the investment cycle and other factors specific to the company, and that the board should both state what that period is and explain why it has been chosen. The FRC considers that this should provide more clarity for boards and more relevant company-specific information for the users of annual reports than the phrase "foreseeable future"; and
- the board should confirm that it has a "reasonable expectation" that the company will remain viable over that period, rather than asserting that it has a "high degree of confidence" as proposed in the January 2013 consultation.

Question 6: Do you agree that companies should make two separate statements? If so, does the proposed wording make the distinction between the two statements sufficiently clear?

Question 7: Do you agree with the way proposed Provision C.2.2 addresses the issues of the basis of the assessment, the time period it covers and the degree of certainty attached?

In the November 2013 consultation, the FRC proposed to incorporate into the integrated guidance document an appendix providing specific guidance on matters to be considered when adopting and reporting on the going concern basis of accounting. Some respondents commented on the detailed drafting, but most considered that it was helpful to provide some guidance on this point. A small number of respondents suggested that the FRC should not issue guidance on applying International Financial Reporting Standards and that it should continue to encourage the International Accounting Standards Board to do so instead. However, the FRC believes it is desirable to issue such guidance, given Lord Sharman's

⁸ Code Provision C.1.1 has been similarly clarified by the addition of "position and".

recommendation to establish a common understanding and the IASB's recent decision not to do so.

The FRC considers that it would also be helpful to provide guidance to companies on matters to be considered when making the proposed broader statement on the company's longer-term viability. Draft guidance on both statements, reflecting comments received on earlier drafts issued as part of the November 2013 consultation, can be found in Appendix B.

Question 8: Do you have any comments on the draft guidance in Appendix B on the going concern basis of accounting and / or the viability statement?

The draft revisions to the Code and guidance do not specify where the proposed broader statement on future viability should be located. One option would be to include it in the Strategic Report alongside the disclosures on principal risks and "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 last year", with appropriate cross-referencing to the statement on the going concern basis of accounting in the financial statements.

As noted in the previous consultation document, the FRC recognises that the FCA's Listing Rules include a requirement for the annual report and accounts to contain "a statement made by the directors that the business is a going concern, together with supporting assumptions or qualifications as necessary". If, as a result of this consultation, the FRC proposes to amend the Code, it will discuss with the FCA whether it would be appropriate for it also to consider a change to the Listing Rules.

Question 9: Should the FRC provide further guidance on the location of the viability statement?

Other reporting requirements

The draft guidance issued for consultation in November 2013 also included a section summarising the various reporting requirements relating to risk, internal control and going concern that are set out in the Code, the Companies Act 2006, FCA Rules and accounting standards. Feedback from respondents was that it was helpful to have such a summary, and it will therefore be retained in the final guidance.

The summary has been rewritten to reflect the proposed revised approach to reporting on the company's viability set out in this consultation document, and is also included in Appendix B for comment. The other parts of the summary, dealing with the Strategic Report, and the requirements in the Code and the FCA's Disclosure and Transparency Rules relating to the risk management and internal control system, are largely unchanged from the earlier draft.

Some respondents raised concerns about the recommendation in the draft guidance that, when reporting on their review of the effectiveness of the risk management and internal control system, "the board should explain what actions have been or are being taken to remedy any significant failings or weaknesses identified from that review". These concerns related to confidentiality and materiality.

The FRC is minded to retain this recommendation in the guidance, as it believes an understanding of how the company has dealt with significant control failures is of legitimate interest to its shareholders. While it is understandable that companies may have concerns about confidentiality and materiality, these are in essence no different to the concerns raised in relation to the changes made to the Code in 2012 asking audit committees to report on the significant issues they had considered in relation to the financial statements, and how these

issues were addressed. Notwithstanding the reservations expressed before those changes were made to the Code, committees are finding ways of reporting meaningfully on these matters.

In that instance, the FRC provided a short piece of guidance which states, in summary, that: the committees will need to exercise judgement in deciding which issues it considered are significant; the statement need not repeat information disclosed elsewhere in the annual report and accounts, but could provide cross-references to that information; and the company would not be expected to disclose information which, in its opinion, would be prejudicial to its interests (for example, because it related to ongoing developments). Consideration could be given to providing similar guidance on this issue.

Question 10: Should the recommendation that companies report on actions being taken to address significant failings or weaknesses be retained? If so, would further guidance be helpful?

Guidance to directors of banks

In the earlier consultation document, the FRC proposed to issue separate guidance to the directors of banks on solvency and liquidity risks and the going concern basis of accounting. Though relatively few respondents commented, those who did were broadly supportive of the value of having separate guidance for banks. The FRC will therefore revise the document as necessary to maintain consistency with the final outcome of this consultation, and the revised guidance will be issued alongside the revised Code.

Auditing standards

In the earlier consultation, the FRC also proposed to issue related changes to the auditing standards previously consulted upon, updated to reflect the other changes to the Code and guidance being proposed and to clarify the requirement for the auditor to report if they have anything material to add to what the directors' have included in the annual report and accounts. Those respondents who commented broadly supported the proposals although a few preferred the FRC to work with the International Auditing and Assurance Standards Board (IAASB) to address these matters internationally.

As noted in the earlier consultation, the changes proposed were consistent with changes the FRC has already made to the auditing standards in the UK and Ireland in 2012, following its 'Effective Company Stewardship' consultation, and the FRC continues to work with the IAASB to ensure that the auditor reporting proposals in the international standards will be able to accommodate the approach to governance in the Code. The FRC will therefore revise the auditing standards as necessary to maintain consistency with the final outcome of this consultation, and the revised standards will be issued alongside the revised Code.

SECTION 4: AUDIT COMMITTEES AND EXTERNAL AUDITORS

In its final report on the market for audit services in FTSE 350 companies, published in October 2013, the Competition Commission (CC) – now the Competition and Markets Authority – made a number of recommendations addressed to the FRC. Some of these would, if implemented, lead to changes to the Code.

Some of the potential amendments to the Code would have been consequential to binding Orders that the CC intended to introduce (for example, to make it a mandatory requirement for FTSE 350 companies to put their external audit contract out to tender at least every ten years, replacing the “comply or explain” provision in the Code). Others would have built on the changes that the FRC made to the Code in 2012 that were intended to lead to more informative reporting by the audit committee.

The CC’s original intention was that its binding Orders would be finalised in the first quarter of 2014, and would take effect from the final quarter. The FRC stated in its annual report on the impact of the Corporate Governance and Stewardship Codes, and in its draft plan and budget, that it would seek views on the implementation of the CC’s recommendations as part of this consultation exercise, and that any resulting changes to the Code would take effect this year.

However, in January 2014 the CC announced that it had decided to defer finalisation of its Orders until the third quarter of 2014. The reason for doing so was so that it could assess the implications of the recently agreed revisions to the EU Audit Directive and the new EU Regulation on the audit of public interest entities. These will lead to new mandatory requirements, some of which overlap with the proposed Orders.

The FRC welcomes the CC’s decision to delay the finalisation of its Orders, and has decided to follow its example and defer consideration of whether to amend the Code until it is next reviewed in 2016. This will enable the FRC to take account of the final Orders and new legislative requirements resulting from the Directive and Regulation, as well as the impact of the changes that were made to the Code in 2012.

However, the FRC does intend to consult separately on guidance to audit committees on how they might report to shareholders on the findings of a review carried out by the FRC’s Audit Quality Review team, where their company’s audit has been subject to such a review. This was recommended by the CC, and some companies have indicated to the FRC that they intend to adopt that practice with immediate effect rather than wait for possible future amendments to the Code.

While the FRC would encourage companies to do so, it believes consistency in the way the information is disclosed would be helpful, not least to reduce the risk that readers of the audit committee’s report will incorrectly conclude that a poor inspection grade implies that the accounts themselves are unsound. Consultation on the guidance is expected to begin in July 2014.

SECTION 5: LOCATION OF CORPORATE GOVERNANCE DISCLOSURES

The Code includes a number of provisions which require companies to disclose certain information in order to demonstrate that they have complied with the Code (for example, information on the composition and activities of the board and its committees and on the use of advisers). These reporting requirements are summarised in Schedule B of the Code.

At present, in the majority of cases, the Code specifies that this information must be included in the annual report and accounts. The FRC would welcome views on whether there would be benefits from amending the Code to give companies the choice of whether to make some or all of this information available on their websites instead; and on whether there are pieces of information required by the Code that are sufficiently important to shareholders that they should always be contained in the annual report or accounts, or which could be dropped entirely as they are of no value to shareholders.

If it is felt that there would be advantages in amending the Code, the FRC will hold further discussions with the Financial Conduct Authority (FCA), the Government, companies and investors with a view to making any resulting amendments when the Code is next reviewed in 2016.

In considering this question, respondents may wish to note that:

- Under the FCA's Disclosure and Transparency Rules, companies are required to produce a corporate governance statement that includes information required under the Code as well as other information (also summarised in Schedule B of the Code). While the Rules give companies the choice of publishing this statement in its annual report or on its website, they do not permit companies to place part of the information in the annual report and the remainder on a website. It would be possible to include a summary of only the most important information in the annual report as long as there is a full statement on the website. As these Rules derive from EU law, the FCA cannot unilaterally amend them to provide more flexibility; and
- Under the FCA's Listing Rules, premium listed companies are required to include in the annual report and accounts a statement of how they have applied the Main Principles of the Code and, where they have not complied with one or more provisions of the Code, an explanation of the reasons why. While the FCA currently has no plans to change these requirements, it has the ability to do so if it considered it appropriate.

Question 11: Should the option of giving companies the possibility of putting the full corporate governance statement on their website be considered further? If so, are there any elements of the corporate governance statement that should always be included in the annual report?

Question 12: Are there any disclosure requirements in the Code that could be dropped entirely?

APPENDIX A – DRAFT REVISED UK CORPORATE GOVERNANCE CODE [SECTIONS C, D & E AND SCHEDULE A]

Note (i): Proposed additions are shown in *bold, italic and underlined text*. Proposed deletions are shown in bold and “strike through” text.

Note (ii): Proposed revisions relating to risk and going concern are in Section C; proposed revisions relating to remuneration are in Sections D and E and Schedule A. No changes are proposed to Sections A and B. Footnotes will be updated once final text is confirmed.

SECTION C: ACCOUNTABILITY

C.1: FINANCIAL AND BUSINESS REPORTING

Main Principle

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

Supporting Principles

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

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

Code Provisions

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

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

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

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.

C.2: RISK MANAGEMENT AND INTERNAL CONTROL

Main Principle

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

Code Provisions

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 – describe those risks and explain how they are being managed or mitigated.

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.

C.2.3 ~~4~~The board should **monitor the company's risk management and internal control systems and**, at least annually, **conduct carry out** a review of their effectiveness ~~of the company's risk management and internal control systems, and should report to shareholders on that review in the annual report. they have done so~~ The **monitoring and** review should cover all material controls, including financial, operational and compliance controls.

C.3: AUDIT COMMITTEE AND AUDITORS

Main Principle

The board should establish formal and transparent arrangements for considering how they should apply the corporate reporting and risk management and internal control principles and for maintaining an appropriate relationship with the company's auditors.

Code Provisions

C.3.1. The board should establish an audit committee of at least three, or in the case of smaller companies two, independent non-executive directors. In smaller companies the company chairman may be a member of, but not chair, the committee in addition to the independent non-executive directors, provided he or she was considered independent on appointment as chairman. The board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience.

C.3.2. The main role and responsibilities of the audit committee should be set out in written terms of reference and should include:

- to monitor the integrity of the financial statements of the company and any formal announcements relating to the company's financial performance, reviewing significant financial reporting judgements contained in them;
- 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;
- to monitor and review the effectiveness of the company's internal audit function;
- to make recommendations to the board, for it to put to the shareholders for their approval in general meeting, in relation to the appointment, re-appointment and removal of the external auditor and to approve the remuneration and terms of engagement of the external auditor;
- to review and monitor the external auditor's independence and objectivity and the effectiveness of the audit process, taking into consideration relevant UK professional and regulatory requirements;
- to develop and implement policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm; and to report to the board, identifying any matters in respect of which it considers that action or improvement is needed and making recommendations as to the steps to be taken; and
- to report to the board on how it has discharged its responsibilities.

C.3.3. The terms of reference of the audit committee, including its role and the authority delegated to it by the board, should be made available.

C.3.4. Where requested by the board, the audit committee should provide advice on whether 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.

C.3.5. The audit committee should review arrangements by which staff of the company may, in confidence, raise concerns about possible improprieties in matters of financial reporting or other matters. The audit committee's objective should be to ensure that arrangements are in place for the proportionate and independent investigation of such matters and for appropriate follow-up action.

C.3.6. The audit committee should monitor and review the effectiveness of the internal audit activities. Where there is no internal audit function, the audit committee should consider annually whether there is a need for an internal audit function and make a recommendation to the board, and the reasons for the absence of such a function should be explained in the relevant section of the annual report.

C.3.7. The audit committee should have primary responsibility for making a recommendation on the appointment, reappointment and removal of the external auditors. FTSE 350 companies should put the external audit contract out to tender at least every ten years. If the board does not accept the audit committee's recommendation, it should include in the annual report, and in any papers

C.3.8. A separate section of the annual report should describe the work of the committee in discharging its responsibilities. The report should include:

- the significant issues that the committee considered in relation to the financial statements, and how these issues were addressed;
- an explanation of how it has assessed the effectiveness of the external audit process and the approach taken to the appointment or reappointment of the external auditor, and information on the length of tenure of the current audit firm and when a tender was last conducted; and
- if the external auditor provides non-audit services, an explanation of how auditor objectivity and independence is safeguarded.

SECTION D: REMUNERATION

D.1: The Level and Components of Remuneration

Main Principle

~~Levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully, but a company should avoid paying more than is necessary for this purpose. A significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance.~~

Executive directors' remuneration should be designed to promote the long-term success of the company. Performance-related elements should be stretching and rigorously applied.

Supporting Principle

~~The performance-related elements of executive directors' remuneration should be stretching and designed to promote the long-term success of the company.~~

The remuneration committee should judge where to position their company relative to other companies. But they should use such comparisons with caution, in view of the risk of an upward ratchet of remuneration levels with no corresponding improvement in **corporate and individual** performance, **and should avoid paying more than is necessary.**

They should also be sensitive to pay and employment conditions elsewhere in the group, especially when determining annual salary increases.

Code Provisions

- D.1.1. In designing schemes of performance-related remuneration for executive directors, the remuneration committee should follow the provisions in Schedule A to this Code. **Schemes should include provisions that would enable the company to recover sums paid or withhold the payment of any sum, and specify the circumstances in which the committee considers it would be appropriate to do so.**
- D.1.2. Where a company releases an executive director to serve as a non-executive director elsewhere, the remuneration report should include a statement as to whether or not the director will retain such earnings and, if so, what the remuneration is.
- D.1.3. Levels of remuneration for non-executive directors should reflect the time commitment and responsibilities of the role. Remuneration for non-executive directors should not include share options or other performance-related elements. If, exceptionally, options are granted, shareholder approval should be sought in advance and any shares acquired by exercise of the options should be held until at least one year after the non-executive director leaves the board. Holding of share options could be relevant to the determination of a non-executive director's independence (as set out in provision B.1.1).

- D.1.4. The remuneration committee should carefully consider what compensation commitments (including pension contributions and all other elements) their directors' terms of appointment would entail in the event of early termination. The aim should be to avoid rewarding poor performance. They should take a robust line on reducing compensation to reflect departing directors' obligations to mitigate loss.
- D.1.5. Notice or contract periods should be set at one year or less. If it is necessary to offer longer notice or contract periods to new directors recruited from outside, such periods should reduce to one year or less after the initial period.

D.2: Procedure

Main Principle

There should be a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in deciding his or her own remuneration.

Supporting Principles

~~The remuneration committee should consult the chairman and / or chief executive about their proposals relating to the remuneration of other executive directors. The remuneration committee should take care to recognise and manage conflicts of interest when receiving views from executive directors or senior management, or consulting the chief executive about its proposals. The committee should be responsible for appointing any consultants in respect of executive director remuneration. ~~Where executive directors or senior management are involved in advising or supporting the remuneration committee, care should be taken to recognise and avoid conflicts of interest.~~~~

The chairman of the board should ensure that the ~~company~~ committee chairman maintains contact as required with its principal shareholders about remuneration.

Code Provisions

- D.2.1. The board should establish a remuneration committee of at least three, or in the case of smaller companies two, independent non-executive directors. In addition the company chairman may also be a member of, but not chair, the committee if he or she was considered independent on appointment as chairman. The remuneration committee should make available its terms of reference, explaining its role and the authority delegated to it by the board. Where remuneration consultants are appointed, they should be identified in the annual report and a statement made of whether they have any other connection with the company.
- D.2.2. The remuneration committee should have delegated responsibility for setting remuneration for all executive directors and the chairman, including pension rights and any compensation payments. The committee should also recommend and monitor the level and structure of remuneration for senior management. The definition of 'senior management' for this purpose should be determined by the board but should normally include the first layer of management below board level.

- D.2.3. The board itself or, where required by the Articles of Association, the shareholders should determine the remuneration of the non-executive directors within the limits set in the Articles of Association. Where permitted by the Articles, the board may however delegate this responsibility to a committee, which might include the chief executive.
- D.2.4. Shareholders should be invited specifically to approve all new long-term incentive schemes (as defined in the Listing Rules) and significant changes to existing schemes, save in the circumstances permitted by the Listing Rules.

SECTION E: RELATIONS WITH SHAREHOLDERS

E.1: Dialogue with Shareholders

Main Principle

There should be a dialogue with shareholders based on the mutual understanding of objectives. The board as a whole has responsibility for ensuring that a satisfactory dialogue with shareholders takes place.

Supporting Principles

Whilst recognising that most shareholder contact is with the chief executive and finance director, the chairman should ensure that all directors are made aware of their major shareholders' issues and concerns.

The board should keep in touch with shareholder opinion in whatever ways are most practical and efficient.

Code Provisions

- E.1.1. The chairman should ensure that the views of shareholders are communicated to the board as a whole. The chairman should discuss governance and strategy with major shareholders. Non-executive directors should be offered the opportunity to attend scheduled meetings with major shareholders and should expect to attend meetings if requested by major shareholders. The senior independent director should attend sufficient meetings with a range of major shareholders to listen to their views in order to help develop a balanced understanding of the issues and concerns of major shareholders.
- E.1.2. The board should state in the annual report the steps they have taken to ensure that the members of the board, and in particular the non-executive directors, develop an understanding of the views of major shareholders about the company, for example through direct face-to-face contact, analysts' or brokers' briefings and surveys of shareholder opinion.

E.2: Constructive Use of the AGM

Main Principle

The board should use the AGM to communicate with investors and to encourage their participation.

Code Provisions

- E.2.1. At any general meeting, the company should propose a separate resolution on each substantially separate issue, and should in particular propose a resolution at the AGM relating to the report and accounts. For each resolution, proxy appointment forms should provide shareholders with the option to direct their proxy to vote either for or against the resolution or to withhold their vote. The proxy form and any announcement of the results of a vote should make it clear that a 'vote withheld' is not a vote in law and will not be counted in the calculation of the proportion of the votes for and against the resolution.

E.2.2. The company should ensure that all valid proxy appointments received for general meetings are properly recorded and counted. For each resolution, where a vote has been taken on a show of hands, the company should ensure that the following information is given at the meeting and made available as soon as reasonably practicable on a website which is maintained by or on behalf of the company:

- the number of shares in respect of which proxy appointments have been validly made;
- the number of votes for the resolution;
- the number of votes against the resolution; and
- the number of shares in respect of which the vote was directed to be withheld.

When, in the opinion of the board, a significant proportion of shareholders have opposed a resolution at any general meeting, the company should explain when announcing the results of voting what actions it intends to take to understand the reasons behind the vote result.

E.2.3. The chairman should arrange for the chairmen of the audit, remuneration and nomination committees to be available to answer questions at the AGM and for all directors to attend.

E.2.4. The company should arrange for the Notice of the AGM and related papers to be sent to shareholders at least 20 working days before the meeting.

Schedule A: The design of performance-related remuneration for executive directors

The remuneration committee should determine an appropriate balance between immediate and deferred remuneration, ~~whether the directors should be eligible for annual bonuses. If so,~~ Performance conditions, including non-financial metrics where appropriate, should be relevant, stretching and designed to promote the long-term success of the company. Remuneration incentives should be compatible with risk policies and systems. Upper limits should be set and disclosed.

The remuneration committee should consider whether the directors should be eligible for annual bonuses and / or benefits under long-term incentive schemes. Traditional share option schemes should be weighed against other kinds of long-term incentive scheme. Executive share options should not be offered at a discount save as permitted by the relevant provisions of the Listing Rules.

Any new long-term incentive schemes which are proposed should be approved by shareholders and should preferably replace any existing schemes or, at least, form part of a well-considered overall plan incorporating existing schemes. The total rewards potentially available should not be excessive.

The remuneration committee should consider requiring directors should be encouraged to hold a minimum number of their shares and to hold shares for a further period after vesting or exercise of an option, including for a period after leaving the company, subject to the need to finance any costs of acquisition and associated tax liabilities. In normal circumstances, shares granted or other forms of deferred remuneration should not vest or be paid, and options should not be exercisable, in less than three years. Longer periods may be appropriate.

Grants under executive share option and other long-term incentive schemes should normally be phased rather than awarded in one large block. There may be a case for part payment in shares to be held for a significant period.

~~Payouts or grants under all incentive schemes, including new grants under existing share option schemes, should be subject to challenging performance criteria reflecting the company's objectives, including non-financial performance metrics where appropriate. Remuneration incentives should be compatible with risk policies and systems.~~

~~Consideration should be given to the use of provisions that permit the company to reclaim variable components in exceptional circumstances of misstatement or misconduct.~~

In general, only basic salary should be pensionable. The remuneration committee should consider the pension consequences and associated costs to the company of basic salary increases and any other changes in pensionable remuneration, especially for directors close to retirement.

APPENDIX B – DRAFT EXTRACTS FROM RISK & GOING CONCERN GUIDANCE

DRAFT GUIDANCE ON REPORTING REQUIREMENTS

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 going concern basis of accounting (as required by accounting standards and the Code);
- reporting on the principal risks facing the company (as required by 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); and
- reporting on the review of the risk management and internal control system (as required by the Code), and the main features of the company's risk management and internal control system in relation to the financial reporting process (as required under the Disclosure and Transparency Rules).

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.

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 of 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.

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 the group faces in relation to its 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.

Going concern basis of accounting

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.

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.

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. 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.

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 X [of the guidance].

Principal risks

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 UK Corporate Governance Code states that the board should confirm that it has carried out a robust assessment of the principal risks and explain how they are being managed or mitigated (Provision C.2.1).

The board should focus on those risks that it considers most important to the future prospects of the company not all potential risks. For example, the Code identifies threats to the company’s business model, solvency and liquidity as matters that should be considered as part of the assessment of the principal risks.

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.

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 effects. Significant changes in principal risks such as a change in the likelihood or possible effect, or the inclusion of new risks, should be highlighted and explained. A high-level explanation of how the principal risks and uncertainties are being managed or mitigated should also be included.

Reasonable expectation that the company can continue in operation

Provision C.2.2 of the Code requires that the directors should state in the annual report and accounts whether – taking account of the company’s current position and principal risks – they have a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due. The Code also states that they should indicate the period covered by this statement and why they consider it to be appropriate, and should draw attention to any qualifications or assumptions as necessary. Further guidance is provided in Appendix X [of the guidance].

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.

Statement on risk management and internal control

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

The board should summarise the process it has applied in reviewing the effectiveness of the system of risk management and internal control. The board should explain what actions have been or are being taken to remedy any significant failings or weaknesses identified from that review. 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.

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.

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.

DRAFT GUIDANCE ON ADOPTING AND REPORTING ON THE GOING CONCERN BASIS OF ACCOUNTING

Determining whether to adopt the going concern basis of accounting

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

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.

The UK Corporate Governance Code provision C.1.3 requires that the directors make an explicit statement 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

Accounting standards also require an assessment to be made of the entity's ability to continue to adopt the going concern basis of accounting.⁹ 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.

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.

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
- 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.

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.

⁹ IAS 1 paragraphs 25 and 26

Reporting on the going concern basis of accounting and material uncertainties

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.¹⁰ The UK Corporate Governance Code provision C.1.3 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.¹¹

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

Where an entity is required to prepare half-yearly financial statements,¹² 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. 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.

¹⁰ IFRIC Update July 2010

¹¹ 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.

¹² Companies listed on a regulated market are required under the Disclosure and Transparency Rules to produce half-yearly financial reports which must include a description of any changes in accounting policies and the principal risks and uncertainties for the remaining six months of the year. Further guidance is available in the FRC's '[Statement on Half-Yearly Financial Reports](#)'.

DRAFT GUIDANCE ON THE LONGER-TERM VIABILITY STATEMENT

Provision C.2.2 of the UK Corporate Governance Code requires directors to state whether, taking account of the company's current position and principal risks, they have a reasonable expectation that "the company will be able to continue in operation and meet its liabilities as they fall due", 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. The directors should also indicate in the annual report the specific period of time covered by their statement and why they consider that period to be appropriate.

Reasonable expectation and period covered

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.

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.

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 / or quantitative tests and analysis, and be as thorough as is judged necessary to make a soundly based statement. Stress tests 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.

The directors should consider the individual circumstances of the company in tailoring appropriate tests and 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 reverse stress tests, which start from a presumption of failure and seek to identify the circumstances in which this could occur.

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

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.

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

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 such 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.



Financial Reporting Council

5th Floor, Aldwych House

71-91 Aldwych

London WC2B 4HN

+44 (0)20 7492 2300

www.frc.org.uk