December 2014

Governance *in brief*
Are you at risk for your new year?

Headlines

- New processes for the ongoing monitoring of risk management and internal control systems need to be in place from the start of your new financial period – from 1 January 2015 for a December year end reporter.
- Remember, risk appetite needs to be decided and risks quantified.
- Clear and rapid allocation of responsibilities for the new requirements is vital if you are not yet prepared.
- Companies need to tell their story in their annual reporting – it is entirely possible we will see a story of gradual implementation.

We are issuing this further briefing to increase awareness as we believe the new requirements need more focus by boards in the corporate sector. The updated UK Corporate Governance Code and the Guidance on Risk management, internal control and related financial and business reporting were published by the FRC in September 2014.

The updates to the UK Corporate Governance Code issued in September 2014 included significant changes to the Code's requirements on risk management and internal control systems. The changes are designed to emphasise the importance of board monitoring of the company's risk management and internal control systems throughout the year, rather than undertaking a one-off, annual review.
The requirements also encourage deeper involvement by boards in risk management and internal controls. The disclosures required for future annual reports (periods beginning on or after 1 October 2014) are a big step ahead of current practice in telling the stewardship story.

> The board should monitor the company's risk management and internal control systems and, at least annually, carry out a review of their effectiveness, and report on that review in the annual report. The monitoring and review should cover all material controls, including financial, operational and compliance controls (Code Principle C.2.3). The board should explain what actions have been or are being taken to remedy any signficant failings or weaknesses (Guidance on Risk management, internal control and related financial and business reporting para 58).

In order to monitor risk management and internal control effectively, boards will need to ensure that processes and information flows are in place to be able to answer the following key questions at regular intervals throughout the year:

- How effectively have risks been assessed, quantified and the principal risks determined?
- How have the principal risks been managed or mitigated?
- Have necessary actions been taken promptly to remedy any significant failings or weaknesses in controls?
- Whether the causes of the failing or weakness indicate poor decision-taking, a need for more extensive monitoring or a reassessment of the effectiveness of management's ongoing processes?

Key challenges

There are a number of challenges arising which need to be addressed.

Robust assessment of principal risks	• Agreeing the level of risk the organisation is willing to take to achieve its strategic objectives (determining its "risk appetite"). • Organisations will have to ensure that they are operating a robust mechanism to identify their 'principal' risks – in addition, organisations will need to assess and disclose both the likelihood and impact of the principal risks identified; both individually and in aggregate. • For many companies this will involve a significant evolution of their risk management processes; especially in the consideration of strategic risks, and how these risks are identified and managed; and in the processes in place to assess and quantify the potential impact of principal risks both individually and in aggregate. • To identify and manage risk effectively and efficiently we believe organisations should consider and challenge how integrated their governance framework is, and how effectively the constituent parts link together.
Longer term viability statement	• Organisations will have to prepare a 'viability statement'; stating that they have a reasonable expectation that their company will remain viable for a period they need to define. The quantification, probablity and timing of the net impact of risks will need to be considered in the viability statement. • Careful consideration will be needed to provide a meaningful statement. • Boards will have to decide early on how much work is required to support their making this statement. In some cases the assessment may be relatively qualitative, for others, more complex modelling solutions may be appropriate.
Monitoring risk management and internal control	• An increased focus on monitoring an organisation's system of risk management and internal control will encourage companies to challenge how effective their current monitoring processes are. • Management should consider a number of aspects of their risk management and internal control monitoring processes: from the management information they collate, to the effectiveness and co-ordination of the various assurance functions within their business, to the opportunities improved technology can bring in real-time understanding of the control environment. • Governance responsibilities in this area will need to be clearly defined.
Risk reporting and disclosure	• External reporting of the principal risks identified will need to become increasingly specific to each company's circumstances. • Disclosure will increasingly focus on how boards are mitigating risks, since reporting now includes likelihood and impact.
Internal control failings and weaknesses	• Companies will need to explain in the annual report what actions have been or are being taken to mitigate significant failings or weaknesses in material controls identified in the period. • As with the viability statement this will require the board to carefully consider what are their "material controls" and what "significant" means in their context and the level of detail to disclose.

Key mobilisation steps

We believe the following key steps are needed to be in a position to start meeting these new requirements:

- Agree a framework for articulating risk appetite.
- Revisit and reassess those risks deemed to be principal risks. Consider the likelihood of those principal risks and the quantification of likely impact, both individually and in aggregate.
- Review the organisation's risk and control governance structure in light of the new guidance to produce a gap analysis.
- Ensure "ongoing monitoring" is built in to the board/committee process and agendas from the start of the year.
- Agree definitions for identifying material controls and review the monitoring and reporting systems which identify significant failings or weaknesses in risk management and internal control systems. Also, consider whether there is a need to revisit internal audit/risk scope and reporting methodology.
- Agree a clear accountability structure and timetabled action plan.

Deloitte view

- For the majority of businesses, especially those in less regulated industries, the adoption of the new requirements and guidance could represent a significant challenge. For example, there now needs to be a clear articulation of risk appetite and principal risks need to be sufficiently quantified; board/committee agendas need to demonstrate sufficient time dedicated to monitoring principal risks on a continuous basis; boards need also to consider if the constituent parts of their governance framework (e.g. management information, technology, assurance) are sufficiently linked together.
- The quantification and scenario planning will directly inform the future viability statement in your annual report (for periods commencing on or after 1 October 2014).
- Early thought should be given to how the board will wish to address the recommendation to "explain what actions have been or are being taken to remedy any significant failings or weaknesses", the definition of which is left to boards. Boards will wish to consider this definition early so they receive scored reports on failings and weaknesses during the year, for example from internal audit, within this new context.
- In due course boards will wish to consider what internal assurance processes they wish to adopt, particularly if they assert a failing or weakness has now been remedied.
- Embraced well, the enhanced risk management processes and disclosures will be a significant step forward in stewardship; embraced reluctantly, little value will be derived and discussions during the 2015 reporting season will be difficult.

To discuss risk and internal controls further please contact

David Noon – 020 7007 3660 or **dnoon@deloitte.co.uk**
Hans-Kristian Bryn – 020 7007 2054 or **hbryn@deloitte.co.uk**

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Contacts and feedback:

Tracy Gordon – 020 7007 3812 or trgordon@deloitte.co.uk

William Touche – 020 7007 3352 or wtouche@deloitte.co.uk

Deloitte LLP is a limited liability partnership registered in England and Wales with registered number OC303675 and its registered office at 2 New Street Square, London EC4A 3BZ, United Kingdom. Tel: +44 (0) 20 7936 3000 Fax: +44 (0) 20 7583 1198.

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