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Governance *in brief*
Risk, internal control and longer term viability – unlocking the value

Headlines

- Most organisations have now completed their first robust assessment of principal risks and longer term viability statement and reported to shareholders under the 2014 UK Corporate Governance Code.
- When done well and thoroughly, businesses have found that the work performed to support the longer term viability statement added a lot of value.
- Widely recognised as a three year journey, regulators around the world are reviewing the UK's experience with interest.
- The first reporters are now half way through Year Two. Boards and management should challenge their Year One approach to ensure they are deriving the most value from the exercise. This Governance in Brief examines how to extract more value and is a timely reminder to look at board agendas for the remainder of the year to do just that.

Background

The first year of reporting under the new UK Corporate Governance Code provisions on risk management has led to a very substantive improvement in the quality of risk reporting in annual financial statements (for an overview of the key changes see **Governance *in brief:* Risk, internal control and longer term viability – how companies have tackled the new Code provisions.**

The biggest individual new reporting requirement has been the new longer term viability statement, in which an organisation states that it believes it is a viable business over a period it has selected (typically three to five years) given the risks it is facing.

The value derived from the work many organisations have done to support the new statement, going beyond mere compliance with the requirements, fulfils one of the underlying intentions of the FRC to join up separate activities within organisations – risk, strategy, operations, treasury, internal audit, finance.

In this paper we identify and explore some of the benefits we have seen to provide companies with areas to consider as they assess how to refine and build on their Year One viability statement work.

Observations from Year One

Bringing risks to life

In order to assess the impact on a financial model of one or more of an organisation's risks occurring within the selected lookout period, companies have had to consider in some depth the impact of the principal risks identified and controls over them. For example, to model the impact of a 'cyber security breach' one has to decide what this particular cyber breach might look like – maybe it brings down one or more of your core systems for a period? Or maybe it results in the loss of a particular data set? Only then can an organisation really start to quantify the impact effectively.

At many of those companies who have embraced a thorough process, the viability statement exercise has led to real improvements in the understanding of potential impacts should risks occur. In some cases this has led to a re-evaluation of whether the matter was genuinely a principal risk, and in others it has resulted in a significantly enhanced understanding of the impacts of the risk and how an organisation can mitigate/respond to them.

Driving better engagement in the risk process

We have also seen a much higher degree of engagement from the board in the risk process, often but not always centred on the new viability statement. This follows the regulator's current philosophy that behavioural change within companies can be driven by introducing new public reporting requirements.

Boards have been closely involved in challenging the risk scenarios presented by management; requesting new scenarios to be run or challenging some of the key assumptions made. This has led to some of the best board level risk discussions we have seen and in some cases led to real changes in the risk profile of the group concerned.

Breaking down silos

In order to do the work to allow the directors to make the viability statement it has often been necessary for Chief Risk Officers to work very closely with colleagues across finance, treasury, internal audit, strategy and operations. These teams will typically 'own' the model an organisation chooses to use and will often have some of the best input in to the quantification of risk impacts and how an organisation might respond (e.g. if top line revenue drops 15% we can reduce operating costs by approximately 10% within 6 months or we can reduce capex by 50% immediately).

This increased collaboration has strengthened the quality and specificity of risk identification and quantification, as well as increasing the effectiveness of scenario planning, as well as enhancing and bringing alive risk as a business rather than a reporting issue.

Making a start on the risk aggregation challenge

Most organisations have more work to do on aggregation of scenarios, but we have seen the viability statement work prompt most organisations to consider the impact of aggregation on organisational resilience, often for the first time. Organisations have typically developed a small number of scenarios to stress test their financial model, selecting a number of principal risks in the lookout period. Sometimes these combinations of risks are linked (e.g. if Risk A happens then Risk B becomes more likely) and sometimes the risks are unconnected and their occurrence at the same time is considered to be just down to bad luck on timing, such as a terrrorist event, poor management of projects or poor financial management.

Understanding risk capacity

The considering of scenarios of multiple risks has also allowed the more sophisticated organisations to consider their 'risk capacity' (essentially 'how much can we take before we break?'). An analysis of risk capacity provides the essential backdrop to the necessary discussion on risk appetite (essentially 'how much risk are we prepared to take on, both in total and for particular risks?'). We anticipate this being an area of increasing focus in Year Two of the new reporting regime.

Getting more value from existing tools or changing tools

Most Chief Risk Officers began their organisation's response to the viability statement requirement with a search across their business for existing models that could be used to underpin and document the necessary work. In the vast majority of cases they found an existing model that could be used, typically cash flow forecasting models or medium term planning tools. Going forward we anticipate CROs will use these models more and more. Planning and forecasting financial models need increasing flexibility to cope with the increasing requests now being made of CROs to model a number of risk scenarios across their business at divisional or business unit level. No doubt this is also partly driven by external factors such as pricing volatility in financial markets and changing business models.

Year Two – areas to consider

We believe that there is a real opportunity for organisations to build on and refine the risk and viability statement work they performed in year one to unlock more value. Treating the new requirements purely as an annual reporting requirement would be a missed opportunity for directors to build a meaningful and useful understanding of the principal risks in their organisations and how they are being managed.

Below we have outlined some of the questions boards could consider asking their organisations – these are those where in our view a response should be available. Some of these relate to the viability statement work discussed in this paper; others to areas of the risk management process where further value can be unlocked.

Risk appetite

- How can we define and develop our organisation's risk appetite further?
- Do we need to do further work to understand and quantify our risk capacity?
- How will we track risk capacity over time, updating it for decisions taken? Are we satisfied that the current level of risk capacity is acceptable?
- How do we monitor our current risk profile against our risk appetite for each principal risk? Who should do this and how often? Is it properly considered in key decisions – for example, buying assets or expanding into new areas?

Risk culture

- Risk culture was a key part of the FRC's guidance questions published to support the changes to the Code – what are we doing to assess risk culture at our organisation?
- What work, if any, needs to be done to further strengthen our risk culture?

Principal risks

- How do we make sure we are properly monitoring our principal risks throughout the period as required by the UK Corporate Governance Code?
- Have we got a clear view on what our material controls are? How do we know these are operating effectively?
- What reporting should we receive on this and how often to comply with the Code's requirement that we monitor material controls?

Viability statement – modelling

- How can we refine the scenarios we stressed our model with? Do we need to model different scenarios?
- Should we model risk scenarios only at the consolidated level? Or should we push this down into the major divisions or operating units in our organisation?
- Do we feel we got the level of detail right first time or can we build on our Year One approach to refine our quantification of risks further, to reveal different issues and different actions required now?
- How do we use the modelling process we have developed throughout the year? Should we use it to inform key decisions? Should the model be part of our ongoing/quarterly risk management review process?

Deloitte View

- The work many organisations have undertaken to support the new viability statement reporting requirements has led to significant value being unlocked above and beyond being compliant with the requirements. However, many organisations got past the post with minimal efforts and so did not access value.
- There remains significant further opportunity to unlock value in Year Two – boards, audit committees, and risk committees should think about this carefully and schedule agendas to examine what was good and what can be improved in Year Two. For the first reporters we are already half way through Year Two.
- The trick is to make risk and control monitoring substantive and embedded in business process, not a year end bureaucratic compliance exercise.
- Finally, consider the scope of internal audit – is it oriented at least in part on what the board believes to be principal risks?

Contacts and feedback – Risk Advisory

Deloitte's Risk Advisory team works with clients to help them manage risk and create value. The team works collaboratively with client organisations to either assess existing processes in place or to assist in the implementation of pragmatic risk solutions.

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