Board Reviews: role of boards in risk management and mitigation (Briefing Paper #3)

Background

It is a core principle of the *UK Corporate Governance Code*[1] (the Code) that the board of a company is responsible for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives. The board should maintain sound risk management and internal control systems (C.2). The reporting requirements under the Code require the board, at least annually, to conduct a review of the company's risk management and internal control systems and should report to shareholders that they have done so (C.2.1). The Code is also explicit that the responsibilities of the audit committee include a review of 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, a review of the company's internal control and risk management systems (C.3.2).

In addition, companies are required by law to describe the main features of the internal control and risk management systems in relation to the financial reporting process (FCA Rule DTR 7.2.5 R). This differs from the requirement in the Code and in practice companies produce a single internal control statement.

Recent Developments

The Financial Reporting Council (FRC) has closely monitored risk management reporting and the going concern basis of accounting, particularly since the Sharman Inquiry[2] finally reported in 2012. The FRC consulted in November 2013[3] on three elements to proposed changes to the Code:

- 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 risk assessment and internal control systems on an ongoing basis, and not rely 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 is now moving to adopt the first two sets of changes but has commenced a new consultation[4] *inter alia* on a revised approach to assessing and reporting on a company's future viability. Extensive draft guidance is appended to the consultation document.

The proposed changes are significant, substantially expanding paragraph C.2 of the Code. The new 'robust assessment' of the principal risks facing the company will require full disclosure and is unlikely to be susceptible to 'boiler-plate' text. The going concern basis note will require detailed explanation of how the board has assessed the prospects for the company, over what period and drawing attention to any qualifications and assumptions as necessary. In addition, there will need to be evidence that monitoring of the risk management and internal control systems is an ongoing exercise (as opposed to an annual one) and that the monitoring is effective.

Board review and audit implications

The audit implications of these changes are well summarised in a note[5] of PricewaterhouseCoopers. 'The formal confirmation from the directors that they have carried out a robust assessment of the principal risks will significantly increase the focus on this area and raise the profile of the related disclosures in the annual report. As a result ... companies will want to revisit the processes and procedures that would support the new formal confirmation. Where companies already have risk management and internal control procedures that are well integrated with their business operations and reporting cycles, they may find that significant changes are not needed. Others will need to make substantial changes ... '

The implications for the board review, especially in years when this is externally facilitated, are also significant. Whereas FRC guidance[6] historically has been limited to a review of the processes for identifying and reviewing risks, the proposed changes to the Code (if adopted) will move risk management centre stage. JWA Governance believes that some companies will want to review the effectiveness of their risk management and mitigation performance annually and do so with the benefit of outside advice and benchmarking, focusing on the role of the board in the process, rather than principally relying on audit assurance that the systems and processes are working.

Methodology for evaluating board effectiveness concerning risk

JWA Governance believes that the challenge for companies will be to integrate fully their risk management processes into the overall governance framework adopted by the board. The board review will focus on how the various elements of the risk management and internal control procedures are coordinated and the way in which risk issues in the business are documented and reported upwards. There may need to be a re-appraisal of not only risk mitigation methods but also the risk appetite for each business, regulatory or other identified risk.

The role of the audit committee will come under additional scrutiny, and certain companies may conclude that a separate risk committee structure is desirable. However, neither of these governance elements of the risk management process will diminish the overall responsibility that the board has for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives.

Conclusion

Boards will need to make more detailed plans for how they comply with these proposed changes and review their effectiveness in monitoring risk management and mitigation procedures. It is to be expected that externally facilitated board reviews will give added emphasis to this area of the Code.

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[1] Financial Reporting Council, *The UK Corporate Governance Code* (September 2012) London: FRC.
[2] Financial Reporting Council, *The Sharman Inquiry: Going Concern and Liquidity Risk, Final Report and Recommendations of the Panel of Inquiry* (June 2012) London: FRC.
[3] Financial Reporting Council, *Risk Management, Internal Control and the Going Concern Basis of Accounting, Consultation on Draft Guidance to the Directors of Companies applying the UK Corporate Governance Code and associated changes to the Code* (November 2013) London: FRC
[4] Financial Reporting Council, *Proposed Revisions to the UK Corporate Governance Code, Consultation Document* (April 2014) London: FRC.
[5] Pricewaterhouse Coopers UK LLP, http://www.pwc.co.uk/finance/corporate-governance/frc-consults-on-sharman-proposals-for-risk-management-internal-control-and-going-concern.jhtml London: PwC.
[6] Financial Reporting Council, *Guidance on Board Effectiveness* (March 2011) London: FRC.