Risk and the Corporate Governance Code

Finding opportunities in the new regulatory challenge

October 2015

EY

Building a better working world

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Foreword

This document is intended to be complementary to EY's March 2015 publication *'The viability statement: finding opportunities in the new regulatory challenge'*.

Whilst the Financial Reporting Council (FRC) has been cautious in its commentary since issuing the new Corporate Governance Code and Guidance, EY has spoken to many of the companies that will be expected to comply. Although there have been few examples of early compliance, companies have discussed their plans and level of preparedness with us. One of the most frequent questions is around how their readiness compares to that of their peers.

Whilst it is impossible to make any definitive statements, it is clear that the more advanced companies are taking steps to make their risk management processes more meaningful and useful, including considering how to build the process of assessing viability into 'business as usual' rather than as 'one-off' tasks, detached from the normal exercise of management.

In this document, we try to provide some insight into emerging good practice, elaborating on areas in which companies are having difficulties.

We have broken the document down into a series of short notes on individual areas, though an important element of good compliance is the 'story' told by the disclosures as a whole.

It is also worth noting that it is not just the disclosures which will be judged by investors, but the whole of the activities that underpin the board's ability to make its statements in the Annual Report.

Changes to the Code

Risk and internal control

C.2 Risk management and Internal control main principle

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

Old:

C.2.1 The board should, **at least annually, conduct a review of the effectiveness of the company's risk management and internal control systems** and should report to shareholders that they have done so. The review should cover all material controls, including financial, operational and compliance controls.

New:

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 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.

The Code

The Code is a guide to a number of key components of effective board practice. It is based on the underlying principles of all good governance: accountability, transparency, probity and focus on the sustainable success of an entity over the longer term.

The UK Corporate Governance Code – September 2014 – 'Governance and the Code'

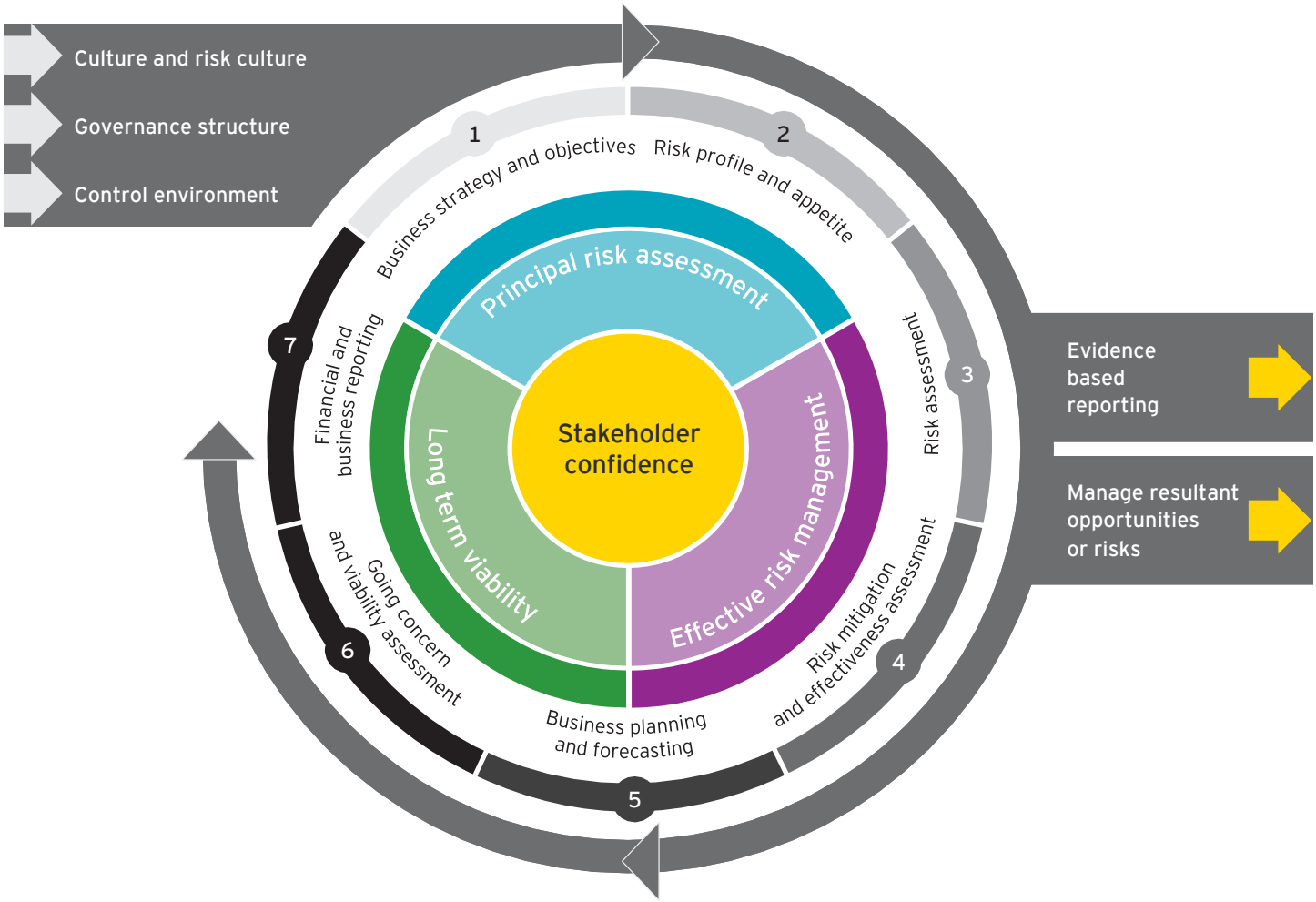
The Guidance

The FRC Guidance aims to:

- Bring together elements of best practice for risk management
- Prompt boards to consider how to discharge their responsibilities in relation to the existing and emerging principal risks faced by the company
- Reflect sound business practice, whereby risk management and internal control are embedded in the business process by which a company pursues its objectives
- Highlight related reporting responsibilities

Guidance on Risk Management, Internal Control and Related Financial and Business Reporting (September 2014) – introduction

Critical factors



1. Risk appetite

> The board has responsibility for an organisation's overall approach to risk management and internal control.
> **The board's responsibilities (include) determining the nature and extent of the principal risks faced and those risks which the organisation is willing to take in achieving its strategic objectives (determining its 'risk appetite').**
>
> FRC 'Guidance on Risk Management, Internal Control and Related Financial and Business Reporting' Sept 2014.

It might be thought surprising that risk appetite has turned into one of the areas with which companies have the greatest trouble. This is not, we believe, because companies are unaccustomed to evaluating what risks they are willing to take, nor does it mean that companies are unwilling to take account of risk in the achievement of their corporate goals. To some extent it is because the term 'risk appetite' is not one that all companies use.

Companies also seem to be wrestling with the intersection of risk appetite and strategic planning and with the idea of making their risk appetite explicit in the Annual Report. As we discuss further, there is a value in making a company's risk appetite clear, as this can ensure that decision making across the organisation conforms more closely to the will of the board. However, we feel it important to make clear that the Code does not require a company's risk appetite to be published.

The FRC's intentions are straightforward – that companies understand the risks that they are willing to take in pursuit of strategic goals and are able to articulate and communicate them, so that they are well understood within the company.

Some insight can be gained from the Financial Services sector, where regulators have been encouraging their firms to set and document risk appetite for some time and have provided considerable guidance on the topic both around the appetite measures themselves and the organisational frameworks that support them.

1. Risk appetite (contd.)

> The business strategy should be supported by a well-articulated and measurable statement of risk appetite (expressed in terms that can be readily understood by employees throughout the business), which is clearly owned by the board, integral to the strategy the board has signed off and actively used by them to monitor and control actual and prospective risks and to inform key business decisions. The Prudential Regulation Authority (PRA) will expect to see evidence of this active oversight of risks according to the risk appetite. The risk control framework should flow from the board's risk appetite.
>
> PRA Consultation Paper CP18/15 Corporate governance: Board responsibilities May 2015

The Financial Stability Board (FSB), which monitors and makes recommendations about the global financial system, proposes that risk appetite frameworks be **informative, effective, embedded and relevant.**

The FSB Consultation Papers provide guidance on what they mean by this:

Informative – i.e., they incorporate processes for communicating internally and to external stakeholders as appropriate

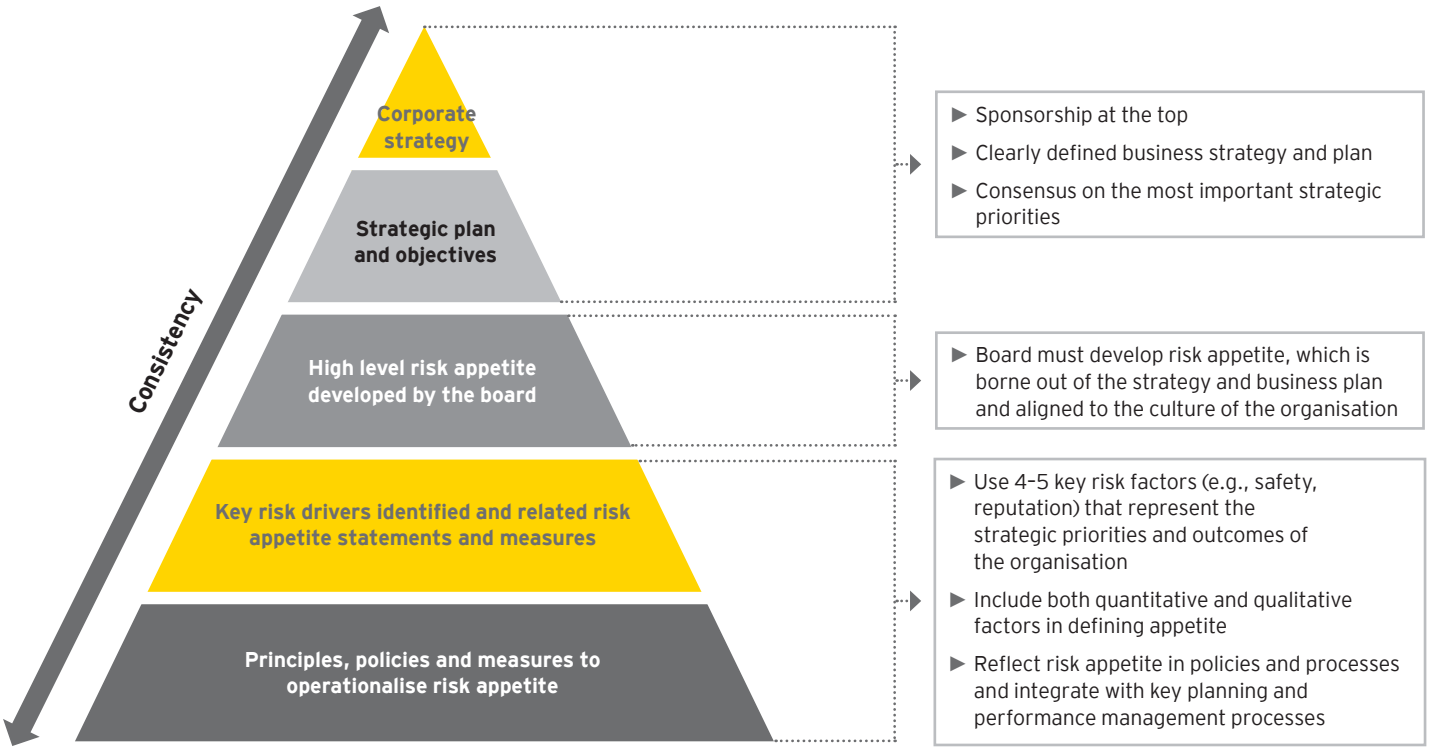
Effective – i.e., they act as a tool for promoting robust discussions of risk at various levels and amongst the control functions and should also be a brake against excessive risk taking

Embedded – i.e., they are driven both by top down board leadership and bottom up involvement of management and are rooted in the company's management culture

Relevant – i.e., they are adaptable to business and market changes, whilst maintaining overall enforcement of the board appetite. Risk Appetite is also a 'live' document; one that evolves with the strategic objectives of the company

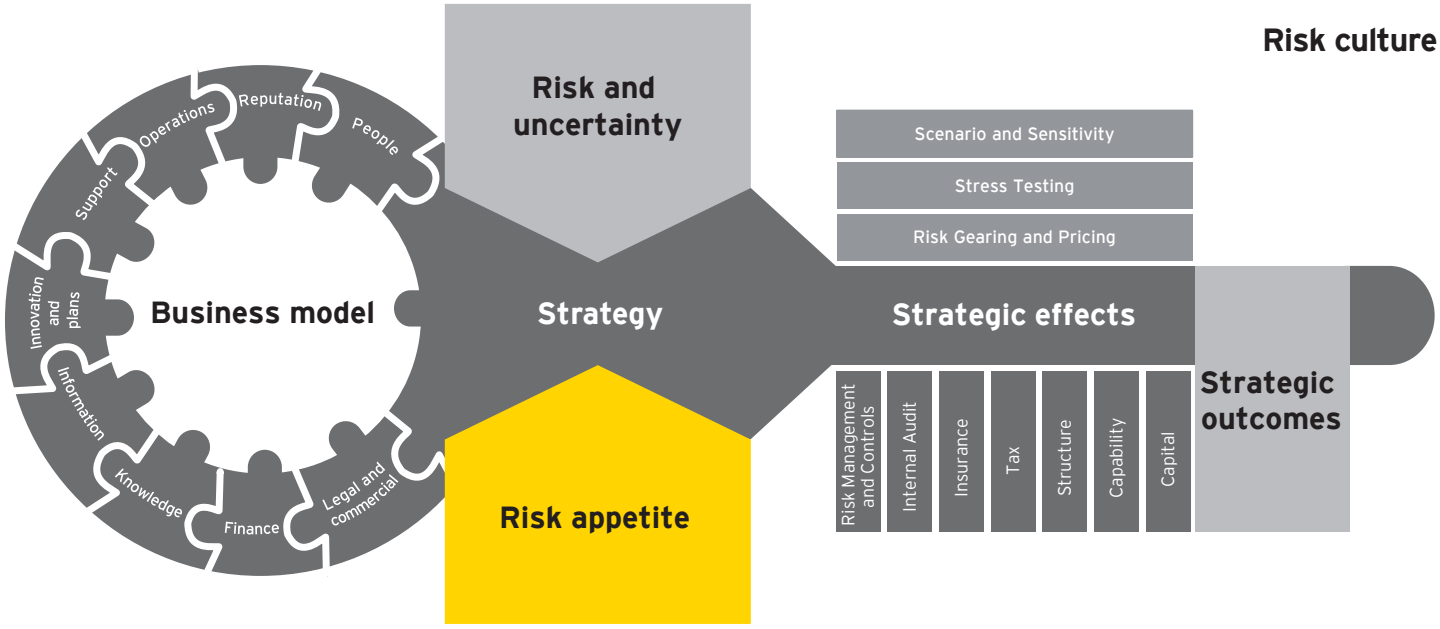
These are sensible criteria and apply equally well to firms outside the Financial Services sector.

In our conversations, setting risk appetite has often been characterised as a complicated and even esoteric exercise. Seen like this, it is very likely to fail. Risk appetite is grounded in what the business actually does and in the real aspirations of the board. A company's risk appetite is implicit in its strategy, however addressing it explicitly brings out any inherent contradictions and conflicts that may even exist within the board itself. It also creates something that can be communicated effectively within the company. The following diagram sets out some advice on how to approach risk appetite:



2. Culture

'What do you really care about?'



Long term viability of the organisation

> Boards have responsibility for shaping the culture, both within the boardroom and across the organisation as a whole and that requires constant vigilance ... Boards should consider what assurance they have around culture. Are performance drivers and values consistent? How can culture be maintained under pressure and through change? Is the culture followed consistently throughout the business? We will be working to promote best practice in these areas during 2015.
>
> Developments in Corporate Governance and Stewardship 2014 (January 2015)
>
> Introduction by Sir Winfried Bischoff Chairman, Financial Reporting Council

> The FRC regards the following as key issues for consideration by companies and investors in 2015:
>
> - The importance of good corporate culture and embedding sound governance behaviours throughout companies
>
> Developments in Corporate Governance and Stewardship 2014 (January 2015)

Although it represents much of what directors and managers talk about when they talk about their companies, many managers and directors are uncomfortable about addressing the idea of 'culture' as a distinct topic.

Whilst 'culture' may vary from company to company, those cultural attributes that manifest in good corporate governance and risk management are strikingly consistent:

- **Tone at the top** – good governance is seen as fundamental and top management: 'walk the talk'. Nothing destroys a good culture quite as quickly as the appearance of double standards at senior levels
- **Cascade** – the ethos of good governance flows down the organisation and is believed, and applied consistently throughout. This can be one of the most difficult elements. This will be covered in more detail
- **Consequences for non-compliance** – belief in the spirit of the culture means that there is no impunity and the application of consequences for non-compliance is applied consistently, i.e., there are no activities or classes of people who are exempt
- **Conscious risk taking** – the application of a strong corporate culture does not mean that risk taking is not tolerated, but it does mean that when risks are taken it is done consciously and as part of the company's overall strategy and appetite
- **Risk transparency** – the risks to the business are well understood

2. Culture (contd.)

Driving the culture through an organisation – embedding it – is often the hardest part of the process. The board may have a clear idea of the sort of corporate culture it wants, however this will not permeate the company without effort. Ideas of good governance will not migrate supernaturally through the organisation and, as well as having a clear idea of what culture it wishes to have, the board will have to provide a framework that ensures that both the organisation as a whole and individual employees are brought within the desired culture.

- At an organisational level the board will have to address the **governance structure** – how are matters identified, escalated and addressed?
- What **people management** measures are in place – what are the training, remuneration and performance assessment processes?
- What kind of **risk and control structures** are in place – risk department, internal audit, explicit risk responsibilities or managers, etc.?
- Finally, how well is the **leadership** itself working toward promoting good corporate culture?

The board should look at its own activities also – is there well informed debate and constructive challenge of management by the board? Does the board have the necessary skills and knowledge to understand the company's risks?

The cascade of the board's desired culture can be made real by setting a hierarchy of accountability that is explicit and extends all the way to the shop floor. A culture can be made real by creating obligations that drive behavioural change.

The logic behind a strong corporate culture is that it will be able to provide a way of imbuing an approach in the business that goes beyond a set of rules, imposed from above or outside the organisation. It provides something that is comprehensive and is hard to manipulate.

3. Principal risk management

3.1 Principal risks

An obvious change between this and the 2012 Code is the use of the term 'Principal Risks' rather than 'Significant Risks'. This represents harmonising the terms used in the 2012 Code and in the Strategic Report and was explained during the debate as the current Code was being drafted:

> 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 ... **The FRC considers that the words 'principal' and 'significant' are interchangeable for the purposes of applying the Code.**
>
> 'Proposed Revisions to the UK Corporate Governance Code' FRC Consultation Document – April 2014

Some companies are wrestling with what should be included as 'Principal Risks'. The FRC has provided some guidance, and we have some further comment based on our own experience as to how these might be identified below.

> A principal risk is a risk or combination of risk that can seriously affect the performance, future prospects or reputation of the entity. These should include those risks that would threaten its business model, future performance, solvency or liquidity.
>
> FRC – Guidance on the Strategic Report (2014)

- The risks should be relevant to the business strategy and consistent with what has been identified in the audit, knowledge of the industry and its business environment
- There should not be so many that the 'real' principal risks are obscured, nor so few that critical risks are not disclosed. Whilst circumstances vary from company to company, it is sensible to question if there are fewer than five or six, or many more than a dozen
- Comprehensive, current and clear information on control, mitigation, velocity and trend direction should be considered
- Both financial and non-financial impacts should be identified and where possible, there should be some quantification at least in broad terms
- Those risks with the most significant implications for liquidity or solvency should be clearly identified

A useful way of thinking about principal risks is by applying the following three categories[1]:

- **Strategic – risks that offer benefits** i.e., those risks that are significant to a company's ability to execute its business strategy and achieve its objectives (e.g., entering new markets). Eliminating these risks is not an option; it is a balancing act that requires the company to evaluate risk versus reward
- **Preventable – risks that offer negative impacts** i.e., risks that a company is focused on avoiding, mitigating or transferring in a cost effective manner, as they offer no strategic benefits (e.g., fraud risk)
- **External – risks that offer negative and/or positive benefits** i.e., risks beyond the company's control. Companies should take what measures they can to cost effectively reduce the likelihood of occurrence and limit the negative effects of their impact should the risk event occur (e.g., natural disaster)

[1]Robert Kaplan and Annette Mikes 'Managing Risks: A New Framework' Harvard Business Review

3.2 Robust assessment

C.2.1 asks that the directors carry out a 'robust assessment' of the principal risks.

What questions should be asked in determining whether an assessment is 'robust'?

- Was it a discussion of the full board? Was it a board committee? Were appropriate non-board managers present?
- Was the information presented up to date? Does it cover risks for joint ventures and outsourced operations?
- Were the supporting papers comprehensive, intelligible and available to the board in good time? Did they document a systematic and coherent picture of the risk and internal control framework, including evidence as to how the risks are mitigated or managed?
- Was the session open and well-structured? Was there enough time?
- Was the interaction of risks discussed? The quantification? The effectiveness of the mitigants?
- Was the output captured and incorporated into the risk documentation? Was it linked to the assessment of prospects of the company – the 'Viability Report'?

4. Risk Management and Internal Control Systems: what should ongoing monitoring consist of?

The Internal Controls section C.2.3 is mainly carried over from C.2.1 in the 2012 Code. The notable change is the addition of a requirement for 'monitoring of' risk management and internal control systems, which adds to the existing obligation to review effectiveness 'at least annually.'

> The board should define the processes to be adopted for its ongoing monitoring and review, including specifying the requirements, scope and frequency for reporting and assurance. Regular reports to the board should provide a balanced assessment of the risks and the effectiveness of the systems of risk management and internal control in managing those risks.
>
> FRC Guidance on Risk Management, Internal Control and Related Financial and Business Reporting – September 2014

In our conversations with clients, the specific reference in the Guidance to 'ongoing monitoring and review' has arisen as a frequent area of focus, with the most common question being: "what constitutes 'ongoing'?".

On-going monitoring and review

The clear intention is that the board's involvement should not be restricted to a single annual review, but whilst the 'ongoing' review need not be taken as a requirement for a managerial role in risk oversight by the board, it is clear that a more active role is expected than was the case under the 2012 Code. More frequent and better reporting to the board will help this, but the quality of the discussion and activity at board level is the best demonstration that monitoring and review are meaningful.

For further insight, a recent PRA Consultation Paper from the Bank of England expands on what is expected of financial institutions:

> The PRA will also expect to see evidence that the board and its relevant sub-committees exercise effective oversight of risk management and controls, supported with meaningful and well targeted management information used to inform board discussions. It is the responsibility of the board to ensure that the effectiveness of the risk control framework is kept actively under review, that it remains aligned with the board's risk appetite, and that the board has the management information it needs.
>
> PRA Consultation Paper CP18/15 Corporate governance: Board responsibilities May 2015

It is therefore not unreasonable to think that this might also be an indicator of better practice for non-financial companies under the revised Code.

4. Risk Management and Internal Control Systems: what should ongoing monitoring consist of? (contd.)

4.1 Risk management system

The first thing to note is that it relates to separate assessments of the systems of risk management and internal control.

It is logical to focus a review of the risk management system on the structures, controls and mitigating actions related to the principal risks identified under Code provision C.2.1.

The annual effectiveness review can then consider more broadly how well the system operates in identifying and managing risks. Also, as the Guidance suggests, the review should include a consideration of how well the system responds to changes in the business or external environment.

4.2 Internal control system

The annual review of the effectiveness of the internal control system is now a well established process that most boards undertake without undue difficulty. However, the additional requirement for ongoing monitoring has raised questions and seems to have caused some companies to question the basis of their existing annual review of the internal control system, even to the extent of asking whether the board has an adequate understanding of how the system operates.

The reference in section C.2.3 of the Code to 'material' controls (something, in fact, present in the 2012 Code) has also prompted some concern. Some question whether this is 'a UK SOX by the back door'. The FRC has been clear that this is not the intention, however it is clearly raising the bar for internal control.

It is difficult to generalise about internal control systems as they are very much driven by the culture and risk appetite of a company, but in order to meet the expectations of C.2.3, we would expect the following elements to be in place:

- A 'top down' view of what the internal control system consists of
- Documentation of the key business processes at a level that provides enough information to be able to identify the material controls. The documentation need not be so detailed that producing or maintaining it is disproportionate to the value of the information created
- Identification of the material controls
- Assessment of material control design effectiveness and the means of monitoring this effectiveness
- An assurance map that identifies the sources and timing of assurance for monitoring control effectiveness

A comprehensive assurance map will allow any gaps or duplications to be identified and will also allow decisions to be taken on the frequency with which control information is reported to the board to allow for ongoing monitoring.

Some companies have started to address this by establishing a head of assurance role that sits above and coordinates internal audit, risk, compliance and other sources of assurance.

5. The Code and narrative disclosure

As well as C.2 Risk Management and Internal Control set out in the foreword, Code principle C.1 also governs disclosure:

C.1: The board should present a fair, balanced and understandable assessment of the company's position and prospects.

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.

There is also some further Guidance on disclosure:

Para 58: Guidance on Provision C.2.3

- The board should summarise the process it applied in reviewing the effectiveness of the systems 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

Para 57: Guidance on Provision C.2.3

In its statement, the board should, as a minimum, acknowledge that it is responsible for risk management and internal control for those systems (and for reviewing their effectiveness) and disclose:

- That there is an ongoing process for identifying, evaluating and managing principal risks
- The systems have been in place for the year under review and up to the date of approval of Annual Report and Accounts
- That they are regularly reviewed by the board
- The extent to which the systems accord with the guidance in this document (Section 5 Para 39–43)

FRC's Guidance on Risk Management, Internal Control and Related Financial and Business Reporting (September 2014)

Nature of the disclosures

... the FRC does not wish to preside over a culture of compliance where 'box ticking' is preferable to thoughtful consideration of the Code's provisions. This detracts from good governance.

Developments in Corporate Governance and Stewardship 2014 (January 2015) – Overview and Assessment

It is clear from the FRC commentary since the publication of the guidance that they strongly wish for companies to avoid 'boilerplate' in their disclosures. Rather than repeating words from the Code, the emphasis should be for companies to explain why they feel that they can make the required assertions, and how they reached their conclusions.

The extent of the disclosure should be influenced by the current state of the company; at the extreme end if a company is in distress, then statements around viability will require a fuller explanation.

5. The Code and narrative disclosure (contd.)

So what makes for good disclosure in this area?

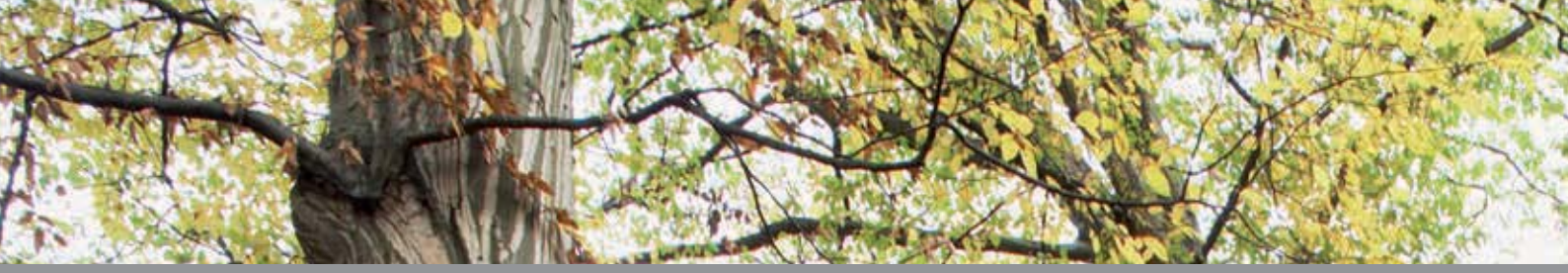
- Disclosures are an outcome – the most critical aspect is the nature of the processes that underpin them
- Disclosures must explain how directors assessed prospects of the company, not simply that they carried out an assessment. Disclosure should therefore provide some colour on what the 'robust assessment of principal risks' comprised, so as to allow the board to reach its conclusion on the company's viability
- Any principal solvency or liquidity risks should be included in the principal risk disclosures, either by explicit designation, or by clearly describing the relevant qualifications/assumptions in the viability statement
- In the spirit of 'Fair, Balanced and Understandable' reporting, there should be a clear flow of all linked disclosures, i.e., primarily the disclosures relating to principal risks, going concern and the viability statement. Companies should consider positioning these disclosures together (ideally in the same section) or in close proximity within the narrative section of the annual report and accounts
- Disclosure should cross reference specifically to any related financial statement disclosures, e.g., capital management disclosures under IFRS (International Financial Reporting Standards)
- Disclosure on the review of internal control and risk management systems should go beyond just stating a review was performed. It should provide insight into the process/activities undertaken as part of the Board's review. It should also explain any outcomes

The essence of the latest changes to the Code is about running companies well for long term success. Disclosures should therefore be fair, balanced and understandable to provide insight to investors about how a company is being run well, including how risks are being assessed and managed, and how directors have been able to reach their conclusions. In light of this, telling a story is important, and ideally the key disclosures in the narrative report should allow a reader to answer the following questions:

- Business model:
  - How does this company make its money?
  - What are the key inputs, processes and outputs in the value chain, and how are its key assets (including its physical assets, IP, people, technology, etc.) engaged in the value chain?
- Strategy:
  - What is the company's competitive advantage?
  - How does the business model help deliver this?
- Risk appetite:
  - What levels of risk is the board willing to take in pursuit of its strategy?
- Key performance indicators (KPIs):
  - What are the key metrics the board uses to measure progress against its strategic objectives?
  - How are these linked to the remuneration of key executives?

5. The Code and narrative disclosure (contd.)

- Principal risks:
  - What are the risks to the successful delivery of the strategy and operation of the business model?
  - What are the risks that pose the greatest threat to the viability of the company?
- Risk management and internal control disclosures:
  - How are the principal risks mitigated and controlled via the company's systems of internal controls and risk management?
  - How does the board monitor material controls on an ongoing basis to get assurance that principal risks are being effectively managed and to take corrective action if not?
  - What did the board's review of the effectiveness of these systems encompass?
  - Has the board identified significant failings or weaknesses?
  - What is the basis for determining what is 'significant'?
  - Is it clear what actions have been taken to address significant failings or weaknesses?
- **Viability statement: having considered all of the above:**
  - **What timeframe has the board considered the viability of the company over and why?**
  - **What process did it use to assess viability?**
  - **What assurance did it obtain over relevant elements? (e.g., stress testing)**
  - **What assumptions did it use in reaching its conclusion?**



6. Issues

6.1 Pension deficit risk

The need to create a Viability Report will expose an issue that affects many companies with defined benefit pension schemes.

Companies with such schemes typically account for the pension liability in accordance with IAS19. This has a number of effects:

- The IAS 19 valuation approach is a balance sheet only approach to liability valuation and has no bearing on the cash flows to be paid to the pension scheme
- The assumptions underpinning the IAS19 valuation are selected by directors and typically are more optimistic than those used by trustees responsible for the pension scheme

Trustees will typically look at the valuation of liabilities through several more prudent lenses, including a going concern view and a solvency view.

In assessing viability therefore, rather than using the accounting basis to value their pension liabilities, most companies should use the trustees' going concern view, i.e., could the company meet its cash flow obligations? In more stressed cases, it may even be more appropriate to look directly to the ability of the company to address its potential solvency liability.

As well as considering ability to meet cash flow obligations, companies should also be considering how volatility in the pension scheme correlates with the volatility in their operations.

Pension schemes are exposed to volatility arising from the asset classes in which they invest and other portfolio factors, e.g., inflation movements, interest rate changes and movements in longevity assumptions. Value at Risk (VaR) measures are used by pension schemes in estimating potential exposure; whilst imperfect, they will lead to a more robust conclusion on financial health.

What should companies be doing?

Firstly, companies need to look at the correlation of risk between the pension scheme and the underlying business. To the extent that there is significant correlation, strategies should be developed to mitigate this, whether it is changing pension scheme investment strategies or hedging to mitigate that risk.

Secondly, given that pension payments can be amongst the more significant outlays a company will make, companies should consider the use of appropriate scenario planning. This will require common sense on both sides, as it is unlikely to be to the benefit of the pension scheme if the liabilities cause the underlying business to fail. Strategies to reduce the risk of failure can include re-profiling payments, offering non-cash assets or in extremis looking to suspend payments. In the most extreme cases, even more drastic strategies are available to ensure corporate survival.

6.2 Confidentiality, liability and 'safe harbour'

When discussing board disclosure on the effectiveness of risk management and internal control, the FRC's Guidance on Risk Management, Internal Control (September 2014) notes that 'the board would not be expected to disclose information which, in its opinion, would be prejudicial to its interests'.

There is also a clarification of the extent of directors' liability in the Companies Act 2006:

(A director of a company) is so liable only if:

- He knew the statement to be untrue or misleading or was reckless as to whether it was untrue or misleading
- He knew the omission to be dishonest concealment of a material fact.

Liability for false or misleading statements in reports, Section 463

It is worth noting also that in these circumstances, the directors are liable only to the company and not to shareholders or other third parties.

This 'safe harbour' protection applies to:

- The strategic report
- The directors' report
- The directors' remuneration report

In 2014, it was clarified that information incorporated by cross-reference into one of these protected reports from other parts of the annual report will be protected if it is there to meet the requirements of the protected reports.

It is worth noting that with respect to some of the more sensitive analysis that supports the board statements, the required disclosures relate to the processes of risk assessment, rather than the quantitative detail of the assessments themselves.

It should also be said that the board should consider seriously its approach to confidentiality:

- Is the information really confidential?
- Are there in fact good reasons for disclosing it? e.g., is its usefulness for investors greater than the value of keeping it confidential?

7. Timeline

An illustrative timeline for a December 2015 year-end

Work already underway

Awareness

- Board briefing to ensure common understanding
- Schedule board meeting to agree the process
- Appoint a point person to drive and own the viability assessment
- Identify all relevant personnel to be involved in key decisions

Planning

- Plan how to coordinate inter-departmental working, e.g., risk, Internal Audit, Treasury, planning and finance

Time horizon and risk

- Agree time horizon to be covered by viability review
- Review board actions to agree risk appetite

Risk and scope

- Consider need for auditor support and advice throughout viability assessment testing
- Review current strategic business plans and forecasting processes to support these
- Consider what documentation is required

September

Analysis

- Determine scope and nature of analysis required
- Review internal skills needed to conduct testing

Strategy and business planning

- Create (or extend current) strategic plan to cover time horizon to be covered by assessment

Modelling

- Create (or extend current) integrated profit and loss, balance sheet and cash flow forecast to cover period of viability assessment

Testing

- Consider dry run of the process

December

Key risks

- Identify key risks impacting on achievement of the extended forecasts
- Model impact of each sensitivity

Sensitivity analysis and stress testing

- Develop a top down integrated financial model to overlay sensitivities on underlying forecasts
- Develop a severe but plausible downside based on stress testing and sensitivity analysis

January

Review

- Board level review of output of business planning and sensitivity analysis
- Board to consider need for external review of strategic plan and supporting model based on impact of downside risks and sensitivities

February

External review

- If required, external testing, review and reporting to board on severe but plausible downside case

Formal sign off

- Board sign off

Planning cycle

- Assess how to embed process changes into the business planning cycle

Timing is now likely to be an issue for companies with early reporting dates falling under the new requirements (i.e., those with reporting dates on or after 30 September 2015).

The board should be given adequate time to absorb the additional obligations and should be made aware of management progress on the supporting processes. This will entail additional information being provided by management to the board over the course of the year, as well as at the formal signoff of the accounts. For management, it is essential that an expectation gap does not develop between what they are doing and what members of the board, and particularly the non-executive members of the board, are expecting.

Putting it all together

1

'Complete the robust assessment of the principal risks facing the company'

2

'Monitor the company's risk management and internal control systems and ... conduct a review of their effectiveness'

3

'Explain in the annual report how the prospects of the company have been assessed' i.e., the Viability Statement

Sources of information	Structural sources of assurance	Assurance activities	Outputs
Risk appetite	Corporate culture	Internal audit	Principal risks
Financial and strategy information	Business line risk management	Risk review and analysis	Viability data
Risk register with risk quantification	Embedded controls	Stress and scenario testing	Remuneration, shareholder relations and diversity information

8. Feedback around the viability statement

In our recent discussions with companies, a number of areas have been focal points for debate:

What is 'severe but plausible'?

'Severe but plausible' is discussed in EY's March 2015 publication 'The viability statement'. As we stated, 'severe' is not the same as 'worst case'.

Although the phrase has been in use for some time in the 'Basel' rules applied to banks, it tends to be defined by specific examples which are not generally useful for non-banking businesses. It has been a working rule that such testing should be seen as a way of examining the particular vulnerabilities of individual entities, rather than a set of mechanistic calculations. This insight is applicable to companies outside the Financial Services sector.

Creating scenarios

The concept of developing scenarios through combining related principal risks in order to quantify the overall impact has been dicussed already. Management teams have started considering how they shape these scenarios through bringing together relevant parties to identify where risks combine and put ranges on the possible impacts.

Mitigation in scenario testing

Management teams have debated the scale of mitigation that can be applied in severe scenario analysis to understand the impacts on solvency and liquidity, rather than the capital position. In this case, it is for management to be candid about the limits to their analysis but also to seek appropriate support if that is what is required. It has to be borne in mind that the role of the board in such circumstances is to critically examine the assumptions made and management's ability to implement its mitigating actions.

Relevant period

There has been considerable variation in responses from companies as to what the appropriate period should be for its viability statement. The key consideration should be the 'fit' to the other cycles in which the company operates, in particular the strategic planning cycle. There may also be other relevant internal cycles (e.g., executive remuneration schemes) and external factors (e.g., franchise lengths, property cycles).

Having said that, we have also seen another factor influencing the decision: the concern that if a company adopts a longer period (say seven years) in the first year but then decides to adopt a shorter period (say five years) in subsequent years, investors may ask why the company has apparently become less sure of its viability. It is possible that in order to avoid this risk companies may prefer to opt for a shorter period in the first year, so that any change is more likely to be one of lengthening the period.

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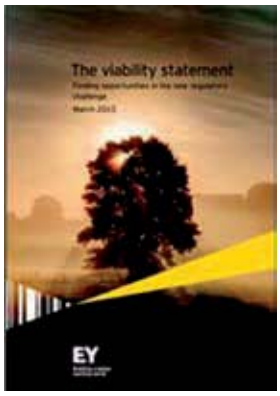
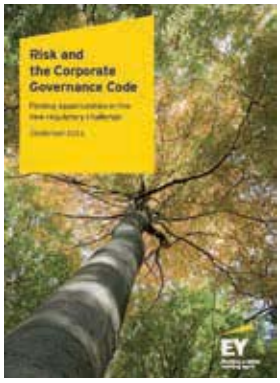
The viability statement



A practical approach to the Viability Statement

- Initial market reaction
- Steps to take immediately
- Quantitative and qualitative approaches
- Choosing the period
- Sensitivity and stress testing
- Comparison with the 2012 Code

Risk and the corporate governance code



Risk aspects, problematic areas and developing good practice

- Risk appetite
- Culture
- Principal risks
- Pension deficit risk
- Disclosures
- Timeline

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