Institute and Faculty of Actuaries

Guidance to Directors on Risk Management, Internal Control and the Going Concern Basis of Accounting

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Question:

A. Have read the guidance and have been / will be working on implications

B. Aware of the proposed guidance and key themes

C. Little knowledge and here to learn

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Why is this topic of interest ?

- Increased focus on risk management across UK businesses
- Opportunity for actuaries ?
  - Can we help companies with implementation ?
  - Can we use our professional connections to speak to companies about risk management ?
- Actuarial Profession Working Party

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Current FRC Guidance for Directors

- Commonly referred to as the “Turnbull” Guidance
- First issued in 1999
- Revised guidance dated October 2005
- The Guidance supports the requirements of the Combined Code (now the UK Corporate Governance Code – September 2012)

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Corporate Governance Code – Risk Management & Internal Control

Main Principle (C2):

The board 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.

Code Provision (C2.1)

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.

Review in 2005

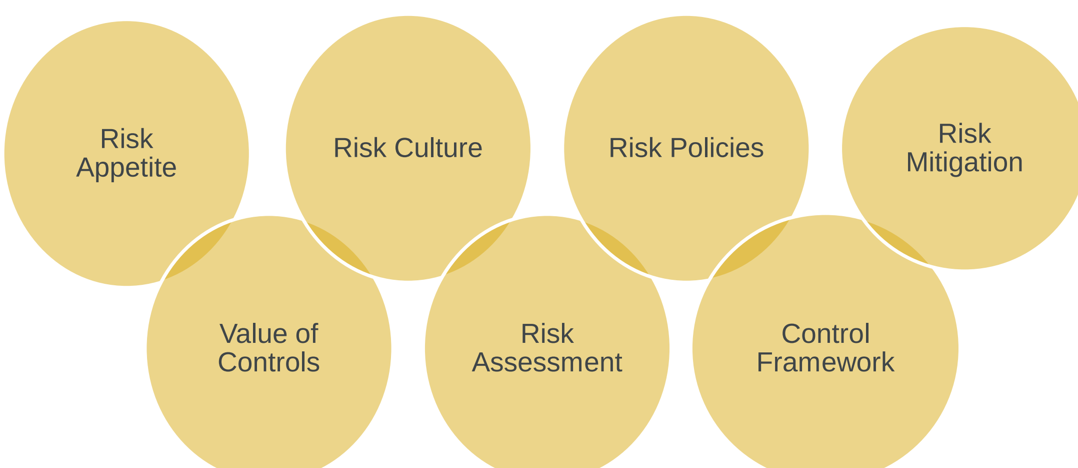
"The principles-based approach has required boards to think seriously about **control issues** and enabled them to apply the principles in a way that appropriately dealt with the circumstances of their business"

".. the companies which have derived most benefit from application of the guidance were those whose boards saw embedded risk management and internal control as an **integral part of running the business**"

Maintaining a sound system of internal control

- Nature and extent of the risks facing the company
- Extent and categories of risks acceptable for company to bear
- Likelihood of the risks materialising
- Ability to mitigate the risks
- Costs versus benefits in managing risks
- Policies, Processes, Tasks, Behaviours

Elements Covered by 2005 Guidance



Annual Review

- Significant Risks – identification, evaluation, management
- Effectiveness of internal controls
- Any significant control failings or weaknesses
- Actions taken to remedy any significant failings or weaknesses

Current Annual Review Process In Practice (example from FTSE 100 insurer)

- Carried out by Risk Function and presented to the Audit (or Risk) Committee of the board
- Senior Management Certification Process
  - Maintained the Risk Management System (incorporating the system of internal control)
  - Reported significant control breakdowns during the year and have taken, or are taking, necessary actions to remedy these reported breakdowns; and
  - Taken steps to identify any relevant information that the external auditors should be made aware of (and have made the auditors aware of any such information).
- Review of Control Issues & Mitigating Actions
- Review of the ERM Framework
- Review of Proposed External Disclosures
- Compliance Review against FRC Guidance

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The New Draft Guidance

30 September 2014

Consultation History

- The Sharman Inquiry
  - Launch – March 2011
  - Preliminary Report – November 2011
  - Final Report – June 2012
- Sharman Implementation Consultation – January 2013
- Risk Management, Internal Control and the Going Concern Basis of Accounting – November 2013
- Proposed Revisions to the UK Corporate Governance Code – April 2014

Corporate Governance Code

Current	Nov 13 Consultation	April 14 Consultation
1. Risk & Internal Control Review 2. Going Concern Statement (Basic)	1. Risk & Internal Control Review 2. Review of Principal Risks 3. Going Concern Statement (Enhanced)	1. Risk & Internal Control Review 2. Review of Principal Risks 3. Going Concern Statement (Enhanced) 4. Statement of reasonable expectation that the company will be able to continue in operation

Corporate Governance Code

C.1.3 Current

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

C.1.3 Proposed

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.

Corporate Governance Code – Risk Management & Internal Control

Main Principle (C2):

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 Provision (C2.1) - NEW

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.

Corporate Governance Code - continued

Code Provision C2.2 – NEW

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 the assessment, drawing attention to any qualifications or assumptions as necessary.

Corporate Governance Code - continued

Code Provision 2.3 – Minor Revisions

The board should monitor the company's risk management and internal control 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.

Introduction

"An understanding of the risks facing the company is essential for the development and delivery of its strategic objectives, its ability to seize new opportunities, and to ensure its longer term survival. It is one of the most important issues with which boards must concern themselves."

"The guidance does not set out in detail the framework by which the company's principal risks are managed or mitigated or through which the board receives assurance. It is for each board to ensure that its framework is robust and effective"

2011 FRC 'Boards and Risk' report and Sharmen Inquiry

High level conclusions:

- The board must determine its willingness to take on risk, and the desired risk culture within the company;
- Risk management and internal control should be incorporated within the company's normal management and governance processes, not treated as a separate compliance exercise;
- The board must make a robust assessment of the principal risks to the company's business model and ability to deliver its strategy, including solvency and liquidity risks. In making that assessment the board should consider the likelihood and impact of these risks materialising in the short and longer term;
- Once these risks have been identified, the board should agree how they will be managed and mitigated, and keep the company's risk profile under review. It should satisfy itself that management's systems include appropriate controls, and that it has adequate sources of assurance;
- The assessment and management of the principal risks, and monitoring of the associated controls, should be carried out on an on-going process, not seen as an annual one-off exercise;
- This process should inform a number of different disclosures in the annual report: the description of the principal risks and uncertainties facing the company in the strategic report; the disclosures in the financial statements on the going concern basis of accounting and material uncertainties thereto; and the report on the review of the risk management and internal control system.

Board risk responsibilities

- Risk appetite
- Risk Culture
- Risk identification and evaluation
- Control, management and mitigation of risks
- Risk management and internal control system
- Management incentives
- Assurance
- External communication

Considerations

- Values and behaviours (communication, incentives etc)
- How to ensure there is adequate discussion at the board
- The skills and experience of the board and management
- The flow of information to and from the board
- Board committees
- Assurance requirements

Identifying & Assessing Principal Risks

- Evaluate likelihood and impact
- Availability & effectiveness of mitigants
- Combinations of risks
- Stress Tests
- Reverse Stress Tests
- Principal solvency and liquidity risks

Establishing the Risk Management & Internal Control System

- Policies
- Culture
- Processes
- Systems

Review

- Continuous monitoring
- Annual Assessment
  - Risk appetite
  - Risk culture
  - Integration of risk management with considerations of strategy and capital and business planning processes
  - Principal risks
  - Risk and internal control system, internal audit and other sources of assurance
  - Assessment of effectiveness of ongoing monitoring
  - Significant control failings or weaknesses
  - Effectiveness of public reporting processes

Communication

- Distinct but related disclosures in the annual report and accounts
  - Reporting on the principal risks and uncertainties facing the company
  - Reporting on the preparation of the financial statements on the going concern basis of accounting and material uncertainties thereto
  - Reporting on the review of the risk management and internal control system (and how they relate to financial reporting process) including extent of compliance with this FRC guidance

Assessing Solvency & Liquidity Risks

- The board needs to have a high level of confidence that solvency and liquidity risk can be managed effectively during at least the twelve month period from the date of approval of the financial statements, or else it is likely to have a going concern material uncertainty to disclose

So what’s new ?

- Solvency and Liquidity Risks
- Stress Tests and Reverse Stress Tests
- More description of expectations and good practice
- New appendices on questions to consider and warning indicators

What does this mean for companies?

- Are enhancements to the Risk Management Framework required ?
- Will annual review processes need to change ?
- Compliance review against the new guidance.
- Questions for the Board to consider (and that the risk team will need to answer!)

Actuarial Profession Working Party

- Multi-disciplinary working group with experience across risk, life, GI, pensions.
- Action Plan:
  - Research Corporate Attitudes & Responses
  - External Events and Engagement
  - Thought Leadership
  - Promotion
  - Internal Events and Training

Questions ?

Discussion Topics

- What are you doing at your company in relation to the new guidance?
- What should the profession be doing to benefit from this opportunity?
- What will **you** be doing to benefit from this opportunity?