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Reputability LLP
Amadeus House
Floral Street
Covent Garden
WC2E 9DP

Tel: +44 20 7812 6690

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Response of Reputability LLP to the FRC's Consultation on Guidance on Risk Management, Internal Control and the Going Concern Basis of Accounting

Reputability is the leading consultancy for educating boards and senior leaders about behavioural and organisation risks and taking them on the steep learning curve to understand and tackle such risks. Reputability can deliver this effectively because of its unique blend of ground-breaking research, experience and expertise.

We welcome the opportunity to comment on the FRC's proposals in this consultation as regards risk management.

We believe that if the corporate catastrophes of recent years, let alone months, have reinforced only one lesson, it is that most big problems ultimately emanate from board level, with human frailty in its many forms frequently a key factor in precipitating the crisis or tipping it into a disaster.

Virtually all the most important behavioural and organisational risks have their origins above the level of risk teams, but most risk teams report to management at or below the level of CFO or CEO. This disconnect is not yet adequately recognised.

The problem is exacerbated because behavioural and organisational risks are not systematically recognised by classical risk analysis, so they remain unmanaged and unnecessarily dangerous at all levels of organisations. The challenge is to find these risks and deal with them before they cause serious harm.

Whilst the FRC appears to be in the lead on dealing with this issue, perhaps because behavioural and organisational risks were first systematically identified and classified in the UK, other regulators both in the UK and internationally appear to be following similar courses, in some cases very close behind the FRC.

Guidance on Risk

Many have wondered why it was possible for multiple bank crises and collapses to happen despite the presence of hundreds of thousands of diligent, competent risk managers in the sector. An important part of the reason is that the science of risk management had not then evolved far enough to bring behavioural and organisational risks, including those at or near board level, systematically under control. This was progressively recognised between 2011 and 2013, as the implications of 'Roads to Ruin'[i], the Cass Business School report for Airmic and Reputability's subsequent report, 'Deconstructing failure – Insights for boards'[ii], emerged. We provided 50% of the research team for the former.

We therefore welcome the FRC's broad recognition of the importance of behavioural and organisational risk and the consequential requirement[iii] that Principal Risks should be disclosed and described "whether they result from strategic decisions, operations, *organisation or behaviour*, or from external factors…" (italics added). Boards and risk teams will ascend a steep learning curve as they acquire the requisite skills.

We welcome that the FRC has drawn attention to particular manifestations of behavioural and organisational risks. With one qualification, to which we will return, we think that the approach adopted, of illustrating a broad sample of risk questions boards may wish to consider in Appendix D and of warning signs in Appendix E represents one of the better available approaches even though it has a fundamental weakness, to which we now turn.

<u>Risks at and from board/executive team level</u>

The draft guidance correctly recognises that behavioural and organisational risks can originate from all levels of the organisation right up to the board. The research, particularly ‘Deconstructing failure - Insights for boards’, demonstrates that board level risks of these kinds *frequently* lie at the root corporate crises and failures.

However the draft guidance implies that a combination of board self-scrutiny combined with scrutiny of board level risks by the internal risk and internal audit teams can in practice draw out any issues there may be.

This is incorrect. It severely undermines the FRC’s good intentions because the research shows that unrecognised board level risks are particularly potent influences in damaging and destroying companies.

There are two points to be considered.

<u>First, it is unrealistic to expect internal risk and internal audit teams to draw out board-level risk issues.</u> Our research shows that large numbers of corporate failures happen in part because of what ‘Roads to Ruin’ described as ‘Risk glass ceiling’ effects. Part of this effect concerns risks at or emanating from board level.

This problem is that risks at or emanating from board level may be recognised from lower levels of the organisation but a variety of obstacles prevent them being raised with upper echelons. These boil down to three main issues that are found to varying degrees and combinations.

- Higher echelons won’t listen to and/or cannot internalise what they perceive as criticism from those with lower status;
- Lower echelons rightly or wrongly perceive the above to be the case and are demotivated from raising such issues with their superiors, and
- Lower echelons rightly or wrongly fear they will face retribution, ranging from discomfort to career termination, if they investigate, let alone comment on what they see as risky behaviour from upper echelons.

Our practical experience confirms this. We regularly encounter senior risk professionals who see even raising the possibility of investigation of risks emanating from the leadership team as potentially too dangerous to contemplate.

In addition few risk professionals yet have the requisite skills systematically to assess behavioural and organisational risk, let alone at board level. They need systematic education in this newly recognised area of risk.

Second, it is unrealistic to expect boards to be able to self-assess risks emanating from themselves and their peers.

The problem is partly that boards too do not yet have the requisite skills to know what behavioural and organisational risks to look for let alone how to find them. Until they have received systematic education on behavioural and organisational risks, including their board-level manifestations, they cannot be expected to carry out any self-assessment let alone supervise the corporate risk system as regards behavioural and organisational risk.

But it is more fundamental than that. No-one can be confident that their own perception of their own shortcomings is accurate.

As long ago as 1786, Robert Burns wrote, in his ‘Ode to a louse’:

> *“O wad some Pow'r the giftie gie us*
> *To see oursels as others see us!*
> *It wad frae mony a blunder free us,*
> *An' foolish notion!”*

Derek Higgs in Annex J of his eponymous Report[iv], wrote:

> “It is the responsibility of the chairman to select an effective [board evaluation] process and to act on its outcome. The use of an external third party to conduct the evaluation will bring objectivity to the process.” (underlining added)

This led to the FRC’s Guidance on Board Effectiveness which recommends an external evaluation of board performance every three years:

> “The Code recommends that FTSE 350 companies have externally - facilitated board evaluations at least every three years. External facilitation

> can add value by introducing a fresh perspective and new ways of thinking." (underlining added)

In her book 'Wilful Blindness', Margaret Heffernan pointed out how cohesive groups, of which boards are but one example, are particularly vulnerable to Groupthink. This typically leads to a breakdown in the independent critical thinking that is necessary if the group is not to become vulnerable to bad and dangerous decisions and a feeling of invulnerability. That is a form of risk blindness that can only be cured by bringing in outsiders.

> "Bringing in outsiders is one way to identify the unconscious knowledge embedded within organisations and bring it to the surface. It can be startling how a little dissent, how even a few questions, can change the tenor of a discussion." (underlining added)[v]

Modern psychologists analyse the problem in terms of phenomena that lead us all to have a view of ourselves that may range from uni-dimensional to delusional. Where teams are involved, groupthink can play an important role. Technical terms they use in their dissection include cognitive dissonance, anchoring, self-serving bias, egocentric bias, confirmation bias, belief bias, framing, overconfidence and neglect of facts.

Following our research, we have concluded that these potentially devastating but hidden risks cannot reliably be brought to the surface and to the board's active cognition without introducing the objectivity and detachment that is associated with a trusted outsider who is:

- trusted by lower echelons as a risk-skilled outsider who understand their concerns and will keep sources of information absolutely confidential; and
- trusted by upper echelons as a dispassionate risk-skilled outsider who can uncover and collect what may be unwelcome perspectives and 'bring truth to power' without fear of future consequences.

Our recommendations to the Financial Reporting Council

A. We recommend the following amendments to the draft Guidance on Risk Management, Internal Control and the Going Concern Basis of Accounting.

1. As regards Paragraph 21, it is unrealistic to expect management to take primary responsibility for identifying and dealing with risks in and emanating from the board. We recommend that Paragraph 21 is revised to add that risks in and emanating from the board are the primary responsibility of the board.

2. As regards the 'Warning Sign' in Appendix E:

   > "*Risk managers and internal auditors are prevented from addressing risk emanating from the upper echelons of the company*"

   we recommend that this should be removed from Appendix E to be translated into Appendix D, under "Risk Assessment" along the following lines:

   > "*To what extent can the board be confident that risk managers and internal auditors can systematically see and deal with risks emanating from the upper echelons of the company including the board, and will report them to the board?"*

3. As regards Appendix D, under 'Risk Assessment, we recommend that there should be added a new question along the following lines:

   > "How does the board ensure that it is able to see, understand and deal with the potentially different perspective on board-level risks that a suitably experienced dispassionate outsider might bring to the board?

B. As regards the FRC Guidance on Board Effectiveness, the FRC has indicated informally that an external evaluation of board effectiveness that approaches board effectiveness from a risk perspective is potentially an acceptable compliance with Part Five of the Guidance on Board Effectiveness.

We recommend that when the FRC comes to revise its guidance on board effectiveness, this should be made clear beyond question.

Footnotes

[i] Available from http://www.reputability.co.uk/files/press/Roads_to_Ruin_The_Analysis.pdf
[ii] Available from http://www.reputability.co.uk/files/press/Deconstructing-failure.pdf
[iii] Proposed in the FRC Exposure Draft: Guidance on the Strategic Report, August 2013
[iv] Available from http://www.ecgi.org/codes/documents/higgsreport.pdf
[v] At page 305