PeterHanleyPH@hotmail.com

23 January 2014

Dear Catherine

FRC consultation: risk management, internal control and the going concern basis of accounting

Thank you very much for the chance to comment. FRC should be congratulated for putting this piece of work on governance together, and inviting comment. The encouragement and nurturing of critical thinking is vital to good governance, and the success of all enterprises across the globe.

I comment as a Systems Thinker and Practitioner with experience of many industries; nuclear, submarines, rail, ports and material handling. In particular I have focused on multi-discipline systems and how they behave, and am a member of INCOSE (International Council on Systems Engineering). As a member of the UK CRSA forum I am excited at the idea that systems thinking can be taken into financial services, in a way that gives the financial sector new tools and perspectives to look at itself. (These comments submitted have been developed entirely independent of anyone else).

Over 20 years ago whilst a Specialist Inspector with the UK Health and Safety Executive, I pioneered a concept which married business finance and safety in a mutually supportive way. This enabled financial flows of the business to be used to identify where safety issues and cost inefficiencies were; and remedies delivered a two-for-one benefit to profit and safety. Financial operations will have a physical asset connected to them at some point, maybe very remotely. Yet as we saw in the 2008 financial crash, liquidity and solvency issues rippled very quickly. Events such as Deepwater Horizon show the connection between financial going concern and safety. New thinking and learning from other industries, if carefully introduced in the financial sector, could start to deliver the desired, stable outcome that is clearly at the heart of the FRC consultation exercise.

55 detailed comments on a clause by clause basis are attached. Each comment has a number, which is marked on the FRC consultation paper and reference to its electronic page number (in the range 1 to 50) and line number. The covering letter on pages 1-3, draws on these comments to provide a summary commentary and answers FRC specific questions.

I apologise in advance if the comments come over direct and harsh. It is the nature of Systems Thinking to be like that. The underlying intent is to tease out issues in as objective a manner as possible. The result is the comments can seem cold and unforgiving. I can assure you that they have been crafted with the greatest of care and consideration to deliver as clear a message as possible.

Summary Commentary

Appendix E of the guidance contains a good responsible intent “to assist boards in assessing how well they are exercising their responsibilities for risk”. Unfortunately, the question set explores minimisation/avoidance of failure. None of the answers to these questions will assist the board in establishing if the entity or system will deliver what they want/wish it to. Thus the answer to the first FRC question (section 2 page 3 electronic page 7) is in short, no. The guidance, however well followed, will only drive avoidance of failure. Without mechanisms for seeking success of the entity, the costs of applying this guidance will increase to an impracticable level; the system will lose what protection it has developed, and then fail.

<u>Question 2; are substantive changes to sections 2 to 6 required? (Page 3, electronic page 7)</u>

See comments 22 to 37 for supporting detail.

More substantive changes are needed to sections 5 and 6. There is too much focus on manipulating risk as an entity and not enough on managing/securing the success of the asset.

Assurance is not defined, and the chance to make comprehensive use of assurance techniques and principles has been missed. For example "Safety Assurance" is defined in the aviation sector as: "*all planned and systematic actions necessary to afford adequate confidence that a product, a service, an organisation or a functional system achieves acceptable or tolerable safety. (Commission Regulation (EC) No 2096/2005);*" The financial sector would benefit from something similar.

<u>Question 3: significant failings or weaknesses guidance. (Page 4, section 2 electronic page 8)</u>

See comments 5 to 6 for supporting detail.

Managing an entity on the basis of "significant failings and weaknesses" is only 50% of the task, and is insufficient to serve as good governance.

<u>Question 4: appendices A to E. (Page 4, section 2 electronic page 8)</u>

See comments 40 to 55 for supporting detail.

Of course directors can make use of any material including these appendices A to E. Directors are free agents.

Like any material, if people come to rely on it, without questioning it, and it inadvertently misleads them, then it is worse than no use.

These appendices need to "paint a picture" of an entity, showing the key functions/operation and how they interact. Then the specific detail in these appendices may help provide some better clues of how to successfully manage the entity.

<u>Question 5 is appendix B appropriate? (Page 6 section 3 electronic page 10)</u>

See comments 41 to 44 for supporting detail.

The idea of addressing solvency and liquidity risks is supported in principle. It is the implementation that is cause for concern.

Much more focus needs to be put on the Cause and Effect relationships, before the detail of this appendix is utilised.

There is a concern that weighting of downside risks may conceal the true nature of the entity and what it communicates to directors.

<u>Question 6 is appendix C appropriate? (Page 7, section 3, electronic page 11)</u>

See comment 45 to 48 for supporting detail.

The principle of working with Going Concern is supported. However, implementation needs more careful consideration.

Human beings operating the entity are implicitly assumed to be clinically rational. The impact of biases that all humans are susceptible to, needs to be integrated into decision-making, if assessment and selection of going concern is to be as valid as possible (as in Behavioural Economics).

The underlying principle of controlling the entity; is that operating outside normal business is actually normal. The within/outside table could mislead people into believing they have "lost" control when in fact the influences on the entity can be controlled by them.

<u>Question 7-no comment</u>

<u>Question 8-no comment</u>

<u>Question 9 new code clause C2 .1? (Page 10, section 4, electronic page 14)</u>

See comment 13 for detail.

In respect of the main principle at C2, renaming 'significant' to 'principal' risks changes nothing; and the new C2 .1 adds little.

The Main Principle does not serve good governance; the willingness to take risks as described, undermines protection of the going concern. So a "robust assessment" delivers no gain.

Once again many thanks for the chance to comment on this very interesting and worthwhile work. I hope your consultation reaps the results you are wishing for.

Kind regards

Peter Hanley

Systems thinking and practice in the finance industry.

DETAILED COMMENT SECTION IN SUPPORT OF PETER HANLEY SUBMISION

(File used: http://www.frc.org.uk/Our-Work/Publications/FRC-Board/Consultation-Paper-Risk-Management,-Internal-Contr-File.pdf)

Comment 1: (Electronic Page 5 ; Section 1 ; Section page 1 ; line: last bullet)

“likelihood and impact of these risks” this illogic is problematic (and self-referencing), whatever definition of risk is used (whether 1. frequency / probability 2. frequency x severity) and suggests either different definitions of risk are being assumed or there is an issue with the risk appraisal / action function in accounting.

Comment 2: (Electronic Page 6; Section 1 ; Section page 2 ; line: first bullet)

“adequate sources of assurance”? 1. Assurance of what? 2. What generic sources are imagined. Assurance typically acts with its focus on the future, that current / proposed decisions are ‘assured’ not to be realised. This acts at a safety level, the discussion of risks in this bullet suggests an adverse outcome which could be expected to occur, yet the executive could rightly expect to be informed of the probability that that prediction (of risk) is violated,-and thus liability (outturn) is greater than expected. Thus assurance (and its intended meaning) ideally needs to be focused on the “good” that the business is desired to deliver. The use of Assurance here (as implied) is focused on the ‘bad’ outcomes, and are they “no bigger than declared?” This binary, uncontrolled definition of assurance has a major impact on the effectiveness of the Internal Control function; is it to maximise the good a business can do, or to minimise the bad a business can suffer?

Comment 3: (Electronic Page 6 ; Section 1 ; Section page 2 ; line: 15) Page 6 item C

“assessing solvency and liquidity risks” is really about survival not thriving, AND may not resonate or harmonise with the “going concern basis of accounting”; which leads to overall failures of the enterprise. The mode of “going concern” needs to be clear, is it 1. a business with enough potential to sell, or 2. a business which is just about breaking even; the way 1 and 2 are run by their leaders are totally different.

Comment 4: (Electronic Page 6 ; Section 1 ; Section page 2 ; line: 13)

“the FRC has decided..”, “to bring its guidance on these matters (RM, IC, GCBoA) in one place..”, “To encourage boards to consider.. RM.. and whether to adopt GCBoA…”

How did the FRC decide this amalgamation of guidance? What structure they have in mind that would systematically connect these 3 components? And do they have in mind that this whole guidance will have greater positive effect than the 3 pieces individually? (as clearly in 3-part form, this wasn’t as good as it needed to be, else we wouldn’t be having this consultation.)

Comment 5: (Electronic Page 8 ; Section 2 ; Section page 4 ; line: 14)

As in Comment 4, the “encourage” mechanism is being deployed. This type of tacit control for remedy of a situation is understandable (in human terms and desires) yet necessarily carries a measure of imprecision which leaves system actions open to interpretation: sometimes varying from that which the 'encouragers' desired. It is suggested that more precision of Design Requirements of Functions (and processes using those functions) is sought, in creating a new / revised code.

Comment 6: (Electronic Page 8 ; Section 2; Section page 4 ; line: 20)

The FRC amendment for greater explicitness is understood, and may well deliver what is written. However the revised text will still produce a measure of "pre-programmed compliance action". Remedial action for identified weaknesses may well appear. However, remedying failings is only 50% of risk management. Companies also need to (for a whole risk management approach) provide remedies to systems, which ensures they continue to function well, under a range of foreseeable conditions; this is the opposite side of the operational coin: opposite 'failings and weaknesses' are 'strengths and resiliences' which need to be maintained.

Fixing the wrong only is no good!

Comment 7: (Electronic Page 9 ; Section 3 ; Section page 5 ; line: 10)

I suspect the recommendations were (deliberately or inadvertently) written at System Function level, and this naturally leaves it open for people to implement in a way their choosing.

I suspect also, that "concerns for implementing (recommendations)" may mean one of several things; regarding the proposed implementation:

1. doesn't deliver the function in whole or in part.

2. changes the function being delivered.

3. delivers a totally different function.

Comment 8: (Electronic Page 9 ; Section 3 ; Section page 5 ; line: 13)

There must have been a reason why "going concern" was deployed with two separate meanings. Now that one group (accounting and auditing) has secured their sole use of this term and its meaning, where does this leave the other group? (And who are they besides not accounting and auditing?)

The text on page 9 suggests the two groups are separated into "financial reporting" and "narrative reporting". The financial group appear to have their term; so this appears to leave the "narrative" based group with no definition of going concern they can use, nor do they have access to the term "going concern" to convey what they mean.

Confusion will still reign, yet this time inside the reported statements, if the "narrative function" is not given definitions to work with.

Comment 9: (Electronic Page 9 ; Section 3 ; Section page 5 ; line: last 3 paras)

This is the unresolved part of Comment 8 above. In the first sentence of the text, the source of the confusion comes clearer. It seems that "going concern" was originally a solely financial statement, and that (enhanced) narrative disclosures have attempted to be added to the overall statement on going concern.

Thus it is clear that neither the financial report nor the enhanced narrative disclosure on their own, are sufficient for “going concern”.

Thus what is needed is one of the following, NOT a hybrid of two incomplete definitions.

1. “Going concern” defined as a composite of financial reporting and narrative disclosure. This package would have to be tested on stakeholders as a viable function, as regards going concern or any other commentary on company accounts.

Or

2. Keep the financial reporting as the auditing / accounting tool for going concern and define the separate purpose of enhanced narrative disclosure. It may then be possible for an additional term to be defined which involves both going concern and enhanced narrative disclosure, such it provides useful information to the relevant stakeholders.

Comment 10: (Electronic Page 10 ; Section 3 ; Section page 6 ; line: 1)

The term “severe distress” needs to be defined so that this definition “principal liquidity and solvency risk” is meaningful, and can give purpose to people’s actions. As it stands, this definition creates ambiguity of position in an assessor’s mind; they need to:

1. Imagine what could “seriously damage” company cash flow, performance or future prospects.

2. Create a definition of “seriously damage” with which to conclude yes or no to item 1 above.

3. Use the deduction result of 1 and 2 above and assess if this would “give rise to severe distress”.

4. Identify to who or what the severe distress is in relation to, (or who / what would hold the perspective of being in severe distress should 1, 2 and 3 be triggered adversely).

5. Define what definition of severe distress is to be used to trigger the yes or no condition.

6. And then put more clarity on the materialisation phase, how much damage and when, and in what form.

Comment 11: (Electronic Page 10 ; Section 3 ; Section page 6 ; line: 12-13)

These two terms (high level of confidence and foreseeable future) have not unsurprisingly provoked concern among stakeholders, as they are being used to pronounce on going concern.

Just based on the text on this page, before going into detail of appendix B, it is possible to say that this approach will not be appropriate, as it is not getting to the needs of company directors to both play up their offering to customers, whilst not falling foul of regulators in overstating their case or position, and open themselves up to prosecution.

There are several Systems Structural issues which need addressing BEFORE any criteria or codes can be crafted.

1. The time frame (s) need to be specific and measurable: “foreseeable” can mean any span of time from 0 hours to millions of years depending on the topic and who is making the judgement on the

viability of the concern. I suggest that several time spans are created; 1, 5, 10, 20 years and commentary is focused on those timeframes.

2. Internal/external company conditions. The text on page 10 talks of “companies own business cycles” (i.e. internal) and “the economic cycle” (i.e. external) in the context of “directors... determining.. Going Concern”. If we rephrase Going Concern as the “absence of company failure” we can see directors are being asked to consider potentially overwhelming amounts of decision variables before they can reach a conclusion, as to yes or no regarding going concern. Part of the decision dilemma is down to only having one blunt tool of risk to use. Another part is that decisions required to take into account the external environment of the economy, with very incomplete information or insight as to how the economy is actually behaving at any one time in the future. Another part is that going concern in its true sense is not being assessed: true going concern would provide some answers or insight as to “how well can the company stand on its own two feet before it is let loose on the world (or into the economy?)”. Asking if an entity (like a knight of old) is in the best possible shape for engaging with the economy IS a question that can be answered, and deficiencies remedied; this process takes place for large military spending projects and involves “safety assurance” of the completed system before going into service. Thus safety assurance is equivalent to establishing if the system will be/is a going concern. Asking if the entity will fail or not is always to invite a probabilistic answer; it can never be 100% fail or 0% fail; the most honest answer without a crystal ball for that system in those (external) conditions, has to be, it may or it may not fail. How far away from 50:50 is not easy to tell. There have likely been systems which on deployment in the economy would have been judged a going concern (under the safety assurance process above) which have failed; AND there have likely been systems on deployment would have been judged NOT a going concern, yet have not failed. Thus a simple linear approach to going concern will not be sufficient for auditing, or narrative purposes.

The key steps for guidance on going concern is that directors and auditors/assessors alike, that the company needs to be able to meet the demands placed on it when it is deployed in the economy or the marketplace. Society will be better served if the distinction is made clear between a). What companies can endure when carrying out the function of the business and b). The pressure that the rest of the companies in the economy can exert on that company at a). The directors judgement can then be expressed about whether in light of b)., the company at a) can survive/thrive, and thus be classed a going concern under those conditions.

Comment 12: (Electronic Page 11 ; Section 3 ; Section page 7 ; line: last sentence)

The addition of “material” simply places more burden on auditors to prove that in the event of things going wrong, they were right or wrong not put in “material”. The word material now holds the whole crux of the concerns around going concern (and associated sub concerns around disclosures, narrative, future, foreseeable etc) without there being a definition of what is meant by material. In industrial safety regulation the terms Technical and Material have been used to distinguish between breaches of law which didn’t expose people to risk (technical) and those that did (material). two types of “anything” make the decision easier. Adding the word material to anything still only leaves one term to trigger a yes/no decision.

Comment 13: (Electronic Page 15 ; Section 4 ; Section page 11 ; line: 2nd para from bottom)

This phrase (with or without the suggested amendment) creates legal liabilities for all company directors and does not accord harmoniously with the concept of 'going concern' addressed extensively in this consultation. The phrase "risks it (the board) is (determining it) is willing to take on achieving its strategic objectives", suggests that Strategic Objectives are higher priority requirements than the (management of) risks; and thus some proportion of care toward risks can be sacrificed if the board is properly focused on its strategic objectives. Here in this code phrase, potentially lies the seed many financial disasters that this code perhaps was/is required to avert.

This phrase clearly establishes that those adhering to this code are stating "the risks they are willing to take". The willingness to take risks -as described- suggests there is a risk (the potential to go wrong), which the board hopes won't materialise and this risk won't be covered <u>and</u> that this is acceptable if it will be instrumental in helping secure their strategic objectives. This suggests a shortfall in protection which is under the direct control of the board. This being the case, this code clause is inciting boards to undermine the going concern nature of the company, in order to secure its strategic objectives. This appears anomalous as you would expect that in order to stand best chance of securing strategic objectives, then the company would need to be the best state of going concern possible. Navigating closer to the edge of failure, would seem to be an unhelpful strategy.

The consequence of imagining boards having the ability to determine what risk (potential for failure) they will leave uncontrolled, is that they have good intelligence where the (external) economy won't put them under pressure. For a board to be able to determine the behaviour that the rest of the economy WON'T exhibit is to require they know the behaviour of the whole system; which is highly unlikely. So for this code clause to then urge the board to maintain "sound risk management" is counter to the behaviour which the first clause is urging. Risk management needs to be coherent and consistent across the sector. This first code clause suggests that the board is setting the company to do a certain job, and is in control of these actions, <u>and</u> thus the board are assuring the safety of the venture; risks which the company may face arise from external demands, which the board can determine a proportionate response to. Thus the code needs to advise boards on the separate topics of risk <u>and</u> safety assurance management <u>and</u> how the two work together.

Comment 14: (Electronic Page 21 ; Section 1 ; Section page 1 ; line: 8)

The use of "sensible" is not helpful in an industry which is demanding so much scrutiny by those both in and outside the industry. "Sensible" suggests an inherent ambiguity in the system which hasn't been resolved.

This sense of ambiguity is reinforced by the word "however" on the next line, suggesting that there is a side to risk which can be more decidable, than that in relation to growth and economic activity. The use of a single word risk to describe both sides of the "company coin" could be one reason why the financial industry is struggling very hard, yet not reaping proportionate rewards on stability and control of its sector.

Comment 15: (Electronic Page 21 ; Section 1 ; Section page 1 ; line: 18)

What does "more insightful" reporting in risk look like? Is this reflected in the code?

Comment 16: (Electronic Page 21 ; Section 1 ; Section page 1 ; line: 30)

"risk culture" is a new term, and needs a definition, if it is to avoid the vagueness of response to the recent fashion to investigate the "safety culture" predominantly in industrial sector organisations.

Comment 17: (Electronic Page 21 ; Section 1 ; Section page 1 ; line: 37)

This is muddled advice, whatever definition of risk is used:

1. Frequency X severity

or

2. Probability of occurrence.

What will the board report on the "likelihood and impact" of either of the above look like? And what good will it serve, even if it could be done; which is probably not the case.

Comment 18: (Electronic Page 21 ; Section 1 ; Section page 1 ; line: last line)

"adequate sources of assurance"; assurance of what?

Comment 19: (Electronic Page 22 ; Section 1 ; Section page 2 ; line: 9)

If risk management is so important, why do board need to be "encouraged" to do it? Is there a fundamental problem with this activity? What stops boards doing it?

Comment 20: (Electronic Page 22 ; Section 1 ; Section page 2 ; line: 11-12)

It is not clear how bringing all guidance in one place, will encourage companies to adopt the "going concern" basis of accounting. Typically, bringing 3 functions together creates a new system behaviour, which requires documentation to be written at a higher (and more holistic) level to embody all the functions. It needs more than hope on the part of FRC to make this new guidance relevant and useful; it is more likely to fragment the industry into strongly divided parts, then create a collective body of collaboration (very much needed).

Comment 21: (Electronic Page 22 ; Section 1 ; Section page 2 ; line: subpara 11; line 1)

I thought the term "best practice" had been replaced by "good practice", to eliminate liability issues for those providing advice.

Comment 22: (Electronic Page 24 ; Section 2 ; Section page 4 ; line: subpara20;)

This makes clear the ambiguity over "going concern". This clause essentially says that a company that is a going concern under financial reporting, may not be a going concern when the risks to solvency or liquidity are factored in. People can't make decisions as to the state of the company and who would want to communicate that situation externally. The solution to the problem(s) presumes a ready resource of correcting agent in the system to bring the particular problem parameter back into its "normal" limits. (Rather like the operation of a toilet cistern). This hinders access to more sustainable and realistic solutions that a healthy system could deliver on.

Comment 23: (Electronic Page 25 ; Section 3 ; Section page 5 ; line: 1)

This is negative injunction phraseology. The ability of the board is something that needs to be developed and nurtured to deliver on its "risk addressing" duties. To start on a negative footing that "the ability of the board… is itself a major risk factor" in effect describes the management of any company to be in a Fail Danger state: i.e. the board is flawed, and its thinking in risk may be flawed, and so it's corrective responses may also be flawed! As this is the very first statement in this section of the code, it is likely the whole section is viewed from this perspective.

Comment 24: (Electronic Page 25 ; Section 3 ; Section page 5 ; line: 15)

This is a well-intentioned phrase, yet if left unchallenged could undermine the ability of this sector to establish and maintain good governance. The idea that effectiveness (success) of a company "ultimately depends on the individuals.. operating the systems" is very common in industrial operations. Here when things go wrong, it is easier to blame the operator, and very often this is what is done; not always with full and proper justification.

It is easy to imagine that as humans we make errors. And so it is easy to conclude that when the system goes wrong that it was due to human error. However, a sustainable (Going Concern) system has to be "safe and fit for purpose" and so an important question to ask is "did the system provoke the human into making an error?" Thus the full Man-Machine Interface is explored. So a key piece of code needs to be added to address where the company can go wrong, and ultimately stop being a "going concern", due to the potential for the engineered/created financial systems to trip the humans into making errors. It is therefore an incomplete governance and risk management arrangement to put simple responsibilities on the operators of the systems; full governance, risk management and internal control additionally requires that responsibilities be put on the designers and builders of those systems put in place.

Comment 25: (Electronic Page 25 ; Section 3 ; Section page 5 ; line: last para)

Why is it only sometimes the opportunities are mentioned for consideration alongside risks? Is this a flaw in thinking? Or simply an inconsistency in approach? Does it show that risk is concerned with the downside only?

Comment 26: (Electronic Page 26 ; Section 3 ; Section page 6 ; line: 1)

The most critical information for a board is (from the Socratic model) what they "don't know they don't know". Existing and emerging risks are to some extent in the known category. Boards need to have processes in place to explore and identify where their knowledge is incomplete.

Comment 27: (Electronic Page 26 ; Section 3 ; Section page 6 ; line: last but one para)

There are two types of "assurance" in relation to systems. 1. Assurance that a system will maintain its integrity under a defined range of demands, whilst continuing to perform its function. 2. Assurance that processes administered to a system, or information about a system, is reliable.

The text on this page appears only to address the second type of assurance: thus boards are not being asked to assure themselves of the condition of the system they are relying on to deliver them profit and returns on investment. Thus the code needs to guide boards to be clear about what assurances they expect to be provided with.

Comment 28: (Electronic Page 27 ; Section 4 ; Section page 7 ; line: 4)

To consider the effectiveness of actions both Pre and Post a triggering event is too complex a set of requirements to be packaged up in the same sentence. Responding to an adverse outcome once it has occurred, requires very different systems and mechanisms to those necessary for forestalling a materialisation of the risks.

Boards who do not have full clarity on the two types of fundamental risk response will be prone to an unexpected risk materialisation, that could perhaps have been prevented or inhibited.

Guidance which does not make the distinction between these two risk responses, is itself likely to be undermined.

Comment 29: (Electronic Page 28 ; Section 5 ; Section page 8 ; line: subpara 34; 1st bullet)

the range and depth of management responses for a board, is not clear here. Having identified "low probability high impact risks" the guidance does not indicate how very different the response to "the higher risk" might need to be. It is clear the Matrix Banding effect is at work here, where " high probability low impact" and "low probability high impact" risks come out numerically similar; the flaw being that when things go wrong, the probability component vanishes, and you're left with very different outcomes. Risks don't become equal because they can be matched at a numerical level.

Comment 30: (Electronic Page 28 ; Section 5 ; Section page 8 ; line: subpara 34; 3rd bullet)

"related risks materialising... as a result or at the same time" implies a very complex arrangement of events, which needs breaking down into components of the business the board can comprehend and deploy/allocate resources to. Too many different issues conflated into one clause, risk nothing being done, or issues being missed.

Comment 31: (Electronic Page 28 ; Section 5 ; Section page 8 ; line: subpara 34; 5th bullet)

This suggests scrutinising controls that weren't deployed. This could be costly and impractical and not necessarily easy for people/boards to ascribe to. The introduction of a Cost Benefit Analysis (CBA) aspect, suggests comparison of options, which suggests some options won't be used.

Comment 32: (Electronic Page 29 ; Section 5 ; Section page 9 ; line: 1)

Incentivising in the effectiveness of the system, is liable to distort the system, culture, values, because the system does not exist solely to be "effective". The system exists to satisfy higher-level goals, which unify the whole operation. This advice could undermine the value of the FRC guidance.

Comment 33: (Electronic Page 29 ; Section 5 ; Section page 9 ; line: last sentence)

"safeguarding of assets" is an important concept; it is different to risk management; and financial controls can both contribute and detract to the "safeguarding of assets (SOA)". SOA is not defined; guidance is needed on this for this guidance to be meaningful.

Thus alongside risk management and internal controls it is recommended that the FRC guides boards in "asset safeguarding" and all that entails.

Comment 34: (Electronic Page 30 ; Section 6 ; Section page 10 ; line: subpara 36)

The use of "processes to be adopted for ongoing scrutiny" might suggest that process scrutiny is adequate. This could direct people away from looking at the inputs and outputs of those processes, and the dynamic relationship between them.

Comment 35: (Electronic Page 30 ; Section 6 ; Section page 10 ; line: subpara 37)

"control failings or weaknesses.. should be discussed". This guidance clause is focusing boards on exception management. In addition boards need to be advised to explore "significant strengths and resiliences" and the contribution to "continued going concern".

This clause only point boards to half the activity set needed to be addressed, the Failure Circuits with no guarantee that all of them will be found. Conceptually looking for what is/has been going wrong is easy, yet it is not a complete process; the inventory can never be considered complete, as something always "might go wrong". A counterbalance of Success Seeking is needed, not a naturally easy concept to explore, because this is not the norm. However, success affects the mind body differently and provides the opportunity for boards to really re-assure themselves of what is good about their operation. A continual diet of dodging the near failures is not healthy, profitable or sustainable.

Comment 36: (Electronic Page 30 ; Section 6 ; Section page 10 ; line: subpara 40; 5th bullet)

"scope and quality of the system" is not adequate scrutiny. The annual assessment needs to provide the opportunity to explore the Whole Life-Cycle of systems and processes, not just operating, yet right back to consideration of whether the design and manufacture of the systems and processes is delivering the operational behaviour that was intended or expected. No matter how well it is monitored and operated correctly, if the system is not right for the company and its purposes, then it needs redesigning or scrapping, just like a piece of machinery.

Comment 37: (Electronic Page 31 ; Section 6 ; Section page 11 ; line: 1st bullet)

A financial company has similar potentials to cause globally experienced side-effects of things going wrong, as a nuclear power reactor. The difference is, that a nuclear power reactor is not operationally managed by how well significant control failings or weaknesses were managed. To have those failings or weaknesses in the first place is considered a management failure. Financial companies need to consider operating from within a zone that doesn't have significant control failings or weaknesses.

Comment 38: (Electronic Page 32 ; Section 7 ; Section page 12 ; line: subpara 43)

"avoid long on detail but short on insight" suggests that information should favour the insight over detail. The definition of "insight" needs to be clarified in the context of this guidance clause.

Comment 39: (Electronic Page 34 ; Section 7 ; Section page 14 ; line: subpara 57)

What does "that system" refer to? Risk management and Internal Control? And is effectiveness alone sufficient? Should it consider how well matched the risk management and internal control system is to the company system?

Comment 40: (Electronic Page 36 ; Section Appendix A ; Section page 16 ; line: 11)

"directors must act... most likely to promote success of the company". It is not clear what governance objective this clause is intended to address. 'Promoting success of company' could be construed as a marketing function which would expect to be done as part of normal business.

Comment 41: (Electronic Page 38 ; Section Appendix B ; Section page 18 ; line: 5th para)

The term "qualitative" needs more precise and useful definitions, in order to address solvency management. The "fit" of internal and external parts of the business is best served by teasing out functionally definable elements and what possible conditions/states they can settle into.

Comment 42: (Electronic Page 38 ; Section Appendix B ; Section page 18 ; line: 6th para)

"sufficient information" is not properly definable or meaningful, if the mechanisms and the way they work are not widely embraced. The linear logic of "if this, then that" can yield much useful information and inform good actions. Yet this is only part of the business management conundrum. There are mixtures of events that create outcomes (and hence information) which can't easily be traced back to a definite Cause of the Effect.

To minimise the materialisation of "unintended consequences" boards need to be guided to examine the relationship(s) between Cause and Effect, recognising that many will be non-linear, yet still requiring a managed response from the board.

Comment 43: (Electronic Page 39 ; Section Appendix B ; Section page 19 ; line: 4th and 5th paras)

The Reverse Stress Test as described is not dissimilar to HAZOPs (hazard and operability studies) used in industrial safety. In the financial industry it is being portrayed as a nice-to-have toolkit, with preference being given to the Stress Test. There is a danger that the two tests become mirror images of each other, which give overoptimistic evaluations of the business model. The word "hypothetical" in the Reverse Stress Test, could imply that this adverse outcome is not really to be expected.

Having two tests apparently working from different directions, provides no assurance to the board, if they falsely corroborate each other.

Guidance needs to address the required independence of the tests from each other, to provide best chance of detecting a flawed business model, and to encourage the introduction of effective and valid business models.

Comment 44: (Electronic Page 39 ; Section Appendix B ; Section page 19 ; line: last line)

By how much "more" are downside risks to be weighted over upside opportunities? This clause is useful for general discussion, yet provides no precision for implementing a system of risk management and internal control.

Who, and how will they look for the distorting effects in the business model of over weighting downside risk? And how will this over weighting at the analysis stage, get harmonised to the comparative weighting of downside to upside risks that Traders and other business model operators naturally default to?

Comment 45: (Electronic Page 40 ; Section Appendix C ; Section page 20 ; line: 2nd para)

This clause has integrated uncertainties which may be beyond management control, and failure of management control.

It is very confusing and could mislead management teams, if their assessment of the entity as a going concern in the light of a range of unknown yet possible circumstances, has to be contrasted against an entity whose controls are deemed to be ineffective or non-existent.

Professional risk (and safety) management would require the identification of how controls may be become ineffective or non-existent, and to devise controls that accommodate human frailties and error making potential, to ensure the overall business model system Fails Safe and self limits the extent of consequences.

This clause needs revisiting so that it doesn't unintentionally suggest to boards that they have to prepare for a time when their controls will be totally inadequate, regardless of what they do.

Comment 46: (Electronic Page 40 ; Section Appendix C ; Section page 20 ; line: 3rd para)

The notion of Severe Distress being a means to determine if actions are Outside Normal Business, runs counter to an effective risk management system.

In industrial safety management, the only actions considered "outside normal business" are acts of God (severe weather catastrophe etc.) or trespass on property or systems. Yet even then the risk management system would expect a response to have been provisioned or discussed by the board beforehand.

The notion of Severe Distress as presented in this text, weakens and undermines the total management of the entity. In the examples of "outside" given in the table on page 41, there is nothing that is actually outside of business normal or otherwise; because they are all business-related events, which would not come into play, unless the entity was brought into existence. Thus, the entity could be said to be Causally Responsible for being exposed to those "outside" issues and thus society could reasonably expect boards to tackle the situation, either in advance or at time of materialising.

It is possible to now see how a "too big to fail" situation could arise; if situations are judged "within" when in fact they have already gone "outside"; and then by the time the true severity is recognised, it is too late to recover, without highest level intervention by governments.

The monitoring of the entity and its position (risk?) needs to be continuous, as identified earlier in this code (see page 21) The existence of a within/outside trigger, then switches position monitoring into a discrete activity, on two different levels of intensity.

Comment 47: (Electronic Page 42 ; Section Appendix C ; Section page 22 ; line: 2nd para)

This guidance appears to be plausible and might work in practice if those making the decisions were clinically rational and did not suffer from bias. However, all humans have Self-Interest and respond to money related biases which affect their decisions without them being aware of it (The Art of Thinking Clearly: R Dobelli).

The guidance needs to alert the reader to the possibility of following these guidance clauses in a linear, reductionist way. Whilst it's all part of being human, it doesn't mean people are behaving badly. They would be allowed to operate, make decisions in a Fail Danger manner, without extra guidance to boost the defences against erroneous decisions.

Comment 48: (Electronic Page 42 ; Section Appendix C ; Section page 22 ; line: 6th para; labelled [c])

This is the first time in the whole document that the term "liquidation basis of accounting" is used. It needs defining. The messages it communicates to shareholders needs to be explored. This basis of accounting needs to be declared as the logical alternative to "going concern basis of accounting" whether the term is declared in the financial report or not.

Comment 49: (Electronic Page 45 ; Section Appendix D ; Section page 25 ; line: 1st bullet)

This question is incomplete and lacks the structure to yield completely useful and meaningful information. The first sentence treats opportunities as if they behave like risks. The capturing of risks associated with opportunities needs to be raised.

The second sentence needs to be separated from the first as they are dealing with risks at different stages of evolution.

Comment 50: (Electronic Page 45 ; Section Appendix D ; Section page 25 ; line: 4th bullet)

"are operating" suggests that controls are active all the time. Some controls only need to operate on demand, and so the question needs to include "would operate" as expected.

Comment 51: (Electronic Page 45 ; Section Appendix D ; Section page 25 ; line: 8th Bullet)

This is one of many "how" questions in this document, which only invites the board to explore if it has a process (of assessment effectiveness). This guidance needs to invite boards to analyse and record the <u>measure</u> of effectiveness of risk management and internal control they believe they have attained. In other words where "how" is used this guidance would do well to consider not only the process, but also the outcome of those processes, as outcomes are more likely to indicate the perceived or actual state of the entity.

Comment 52: (Electronic Page 45 ; Section Appendix D ; Section page 25 ; line: 9th bullet)

Risk management systems will find it difficult to be holistic if the entity operations are managed in silos. This clause is implicitly asking risk management systems to do the governing of the entity, when in fact it is a collaboration of many systems which delivers the overall silo or holistic effect.

Comment 53: (Electronic Page 45 ; Section Appendix D ; Section page 25 ; line: 10th bullet)

These clauses are described being REACTIONS to deficiencies. This mode of operating the entity, it's risk management or internal control is not sufficient in itself. Clauses are needed to:

1. Ensure systems do not create or act as cause of deficiencies.

2. Pre-empt or act in advance of deficiencies arising.

Comment 54: (Electronic Page 46 ; Section Appendix D ; Section page 26 ; line: 1st bullet)

This clause proves and delivers little of use, so could be a waste of resources.

This guidance could consider inviting boards to ask their shareholders what THEY think of the reports and information they receive.

Comment 55: (Electronic Page 47-48 ; Section Appendix E ; Section page 27 ; line: whole Appendix)

To the untrained eye and mind, this looks a good and useful set of questions to ask. The questions might produce some limited good, yet none of the match the initial stated intent of appendix E, whose component parts are:

1. How well are boards exercising their responsibilities for risk.

2. Is the culture what they wish it to be.

3. Is risk management and internal control operating effectively.

All the questions without exception are in fact asking “where are we getting the least of what we DON’T want/wish for?”

Appendix E embodies all the hallmarks of a system monitor which will NOT help entities to succeed, and provide no intended guarantee the entity won’t fail, due to management (risk management and internal control) intervention.