

**Response to Financial Reporting Council (FRC)
Consultation Paper 6th November 2013**

**Risk Management, Internal Control and the Going
Concern Basis of Accounting**

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Fifth Floor
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22nd January 2014

Dear Catherine,

I would like to start by acknowledging the important role of the FRC in setting codes and standards in the UK financial sector in order to help foster the conditions for sustainable long term investment. In this regard I would like to commend the FRC in its ongoing efforts to improve the quality of corporate governance and standards of professional practice within the sector, and in particular its current efforts to further improve its guidance in the area of risk management and internal control.

Clearly ongoing events continue to highlight various weaknesses and deficiencies in existing financial oversight frameworks, and highlight the requirement for an improved approach in order to better safeguard the interests of the multiple stakeholders. The FRC is therefore in a unique position to help address these weaknesses and help improve ongoing oversight within the financial sector.

I would like to state for the record that in my opinion this consultation document is a welcome compliment to existing guidance. My feedback is therefore not intended to be a criticism in any way, but rather a constructive attempt to contribute to further improvement in this space. My attached comments address what I believe is a fundamental requirement to adopt a more holistic high level inter-disciplinary approach in order to help ensure that there is strategic alignment and tactical integration of the ongoing efforts in risk management, internal controls and beyond.

I would like to thank the FRC for providing this opportunity to comment on the consultation document. Should you require any additional information or wish to discuss any of the issues raised in more detail please do not hesitate to contact me.

Yours sincerely

Sean Lyons

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Selected Corporate Defence Publications: <http://ssrn.com/author=904765>

1. Addressing the High Level Value Preservation Imperative

The FRC's efforts to help foster the conditions for sustainable long term investment in the UK financial sector are intertwined with its responsibilities to help safeguard stakeholder value in the financial sector and indeed in broader society. In the financial sector the delivery of value over time (short, medium, and long term) typically focuses on the value creation process.¹ Recent history has shown that short-termism is overly concerned with increasing stakeholder value in the short term without due regard for how stakeholder value can be sustainability delivered (created and preserved) over the longer term. Ensuring greater focus on how stakeholder value is sustainably created and preserved has to be central to the FRC's ongoing efforts.²

Prudence and common sense would suggest that the delivery of sustainable stakeholder value over the short, medium, and long term requires a healthy blended approach. It is therefore imperative that there is a disciplined balance between the focus on value creation (offence) and the focus on value preservation (defence).³ In essence the principles of offence and defence represent two sides of the same coin and therefore cannot and should not be addressed in isolation of one another.

Events in the financial sector continue to indicate an imbalance between offence and defence, with a disproportionate focus on the former while often neglecting the latter. It represents a defence deficit. Such a mindset has resulted in excessive risk taking in search of short term rewards at the expense of longer term sustainability. Addressing this matter will require a notable correction to the current imbalance in order to create a natural harmony between these two antagonistic yet complimentary principles. While the FRC continues to address certain important individual issues such as corporate governance, risk management and internal controls etc, it is now time to address this matter from a more strategic perspective and start to focus on the forest rather than the trees.

Recommendation: In order to achieve its objective of fostering the conditions for sustainable long term investment in the UK financial sector the FRC's high level focus should first and foremost be on how financial organisations are addressing this value preservation imperative at a strategic level:

- *Does the organisation's strategy (and/or business model) formally address value preservation (and its defence objectives)?*
- *Are the organisation's defence objectives formally documented?*
- *Are its defence objectives clearly in alignment with the organisation's overall strategic objectives?*
- *Does the organisation have a formal defence strategy in place to help achieve its defence objectives?*
- *If not why not?(to all of the above)*

¹ The IIRC's **Integrated Reporting International Framework** identifies the value creation process as also incorporating both value preservation and value diminution (See Fig 2, page 13)

² **UK Corporate Governance Code:** Provision C.1.2 states that "the directors should include in the annual report an explanation of the basis on which the company generates or preserves value over the longer term (the business model) and the strategy for delivering the objectives of the company".

³ Please see my HBR/McKinsey M-Prize (Long-Term Capitalism Challenge) submission entitled "**Achieving a Healthy Balance Between Offense and Defense in 21st Century Capitalism**"
http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2157182

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2. The Requirement for an Overarching Interdisciplinary Framework

In this context the value preservation imperative relates to the organisation's obligation to take the necessary steps to help preserve stakeholder value. This includes the defence framework in place to proactively mitigate against the occurrence of value diminution or erosion. A defence framework in its broadest sense represents an organization's collective program (formal or otherwise) for self-defence. It represents the measures taken by an organisation to defend itself and the interests of its stakeholders from a multitude of potential hazards (risks, threats, and vulnerabilities), the occurrence of which could be detrimental to the achievement of the organisation's objectives. This includes the management specific defence related activities which have been identified as the critical components of a comprehensive defence program (i.e. Governance, Risk, Compliance, Intelligence, Security, Resilience, Controls, Assurance)

Effective defence management requires an appreciation of the continuous interaction, interconnections, and critical interdependencies which exist between these components and an understanding that the management of these complimentary components continuously impact on one another in this increasingly complex financial ecosystem. In fact developments in each of these areas has meant that the boundaries between these components have become increasingly blurred and it is now increasingly difficult to determine where one component ends and another begins as each includes elements of the others.

Successful defence requires managing all of these critical components in an integrated manner at strategic, tactical, and operational levels. This requires a coherent and comprehensive framework which addresses the organisation's defence responsibilities and accountabilities in a transparent manner across the organisation's five lines of defence.⁴ The five lines of defence include:

1. Operational Line Management (The Business)
2. Tactical Oversight Functions (Risk Management, Compliance etc)
3. Independent Internal Assurance (Audit Committee and Internal Audit)
4. Executive Management
5. The Board

Recommendation: In order to help financial organisations address their value preservation obligations the FRC should prioritise providing guidance on a suitable overarching framework to help organisations to integrate their critical defence components across their five lines of defence. Such a framework should help ensure clear transparency in relation to an organisation's defence responsibilities and accountabilities at strategic, tactical, and operational levels.⁵

⁴ Please refer to the Conference Board Executive Action Report No. 365 entitled “**Corporate Oversight and Stakeholder Lines of Defense**” - http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1928360

⁵ Please refer to **Appendix** for an example of such a multi-dimensional framework

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3. The Requirement for Integrated Guidance

Each of the individual critical defence components has an important role to play in value preservation and in helping an organisation to deliver sustainable stakeholder value.

Critical Components of a Defence Program

Governance: How the organisation is directed and controlled, all the way from the boardroom to the factory floor.

Risk: How the organisation identifies, measures and manages the risks it is exposed to.

Compliance: How the organisation ensures that its activities are in conformance with all relevant mandatory and voluntary requirements.

Intelligence: How the organisation ensures that it gets the right information, in the right format, to the right person, in the right place, at the right time.

Security: How the organisation ensures that it protects its critical assets from threats and danger, its people, information, technology and facilities.

Resilience: How the organisation ensures that it has the capacity to withstand, rebound or recover from the direct and indirect consequences of a shock, disturbance or disruption.

Controls: How the organization ensures that it has taken appropriate actions in order to address risk and to help ensure that the organization's objectives will be achieved.

Assurance: The system in place to provide a degree of confidence or level of comfort to the stakeholders that everything is operating in a satisfactory manner.

It is important that financial organisations clearly understand and fully appreciate the important roles each of these components⁶ has to play, both individually and collectively, and therefore where ever possible guidance should address these topics in an integrated manner rather than addressing individual components in isolation. To date the FRC has provided specific codes⁷ and guidance⁸ on a number of these components individually, and in certain cases has clearly made efforts to integrate these components by combining them and also cross referencing other relevant documents.⁹ A more strategically integrated approach to guidance is however still required in this space.

Recommendation: The FRC should continue to provide ongoing holistic guidance in relation to these critical defence components both individually and collectively all the while ensuring that this guidance is strategically, tactically, and operationally integrated and in alignment.

⁶ Please refer to my Q&A publication **Corporate Defense Insights: Dispatches From the Front Line** http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1337635

⁷ For example the **UK Corporate Governance Code** etc

⁸ For example the **Exposure Draft: Guidance on the Strategic Report** etc

⁹ For example the current consultation paper **Risk Management, Internal Control and the Going Concern Basis of Accounting** etc

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Corporate Defense Management (CDM) Framework

Figure 1: Critical Components

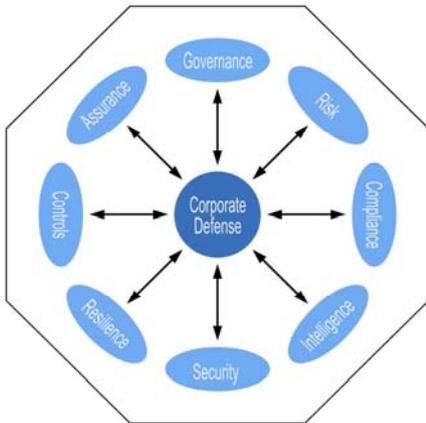


Figure 2: Five Lines of Defense

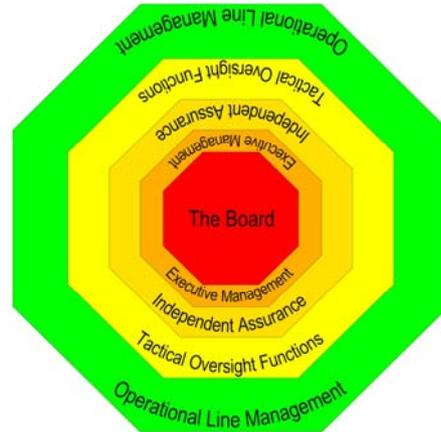
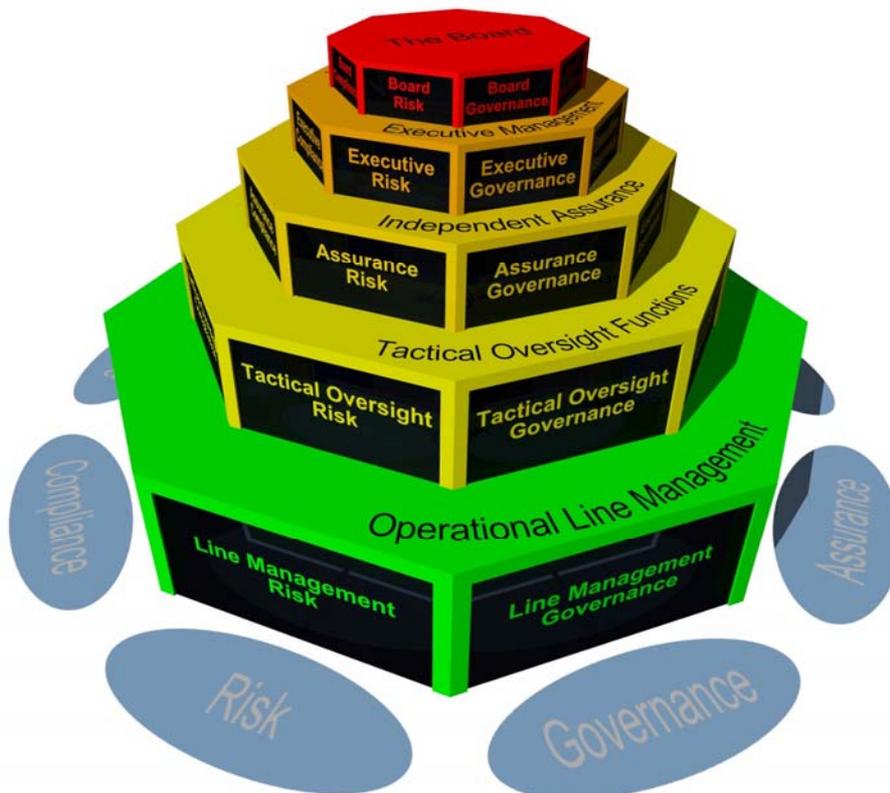


Figure 3: Multi-dimensional CDM Framework¹⁰



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¹⁰ Please refer to short video which provides a visual image and overview of the workings of this multi-dimensional framework: <http://www.youtube.com/watch?v=vLoA8U0GZHI>

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