



## Governance *in brief*

### Risk, internal control and viability – how September year end reporters have tackled the new Code provisions

#### Headlines

- No companies reported any non-compliance for either the whole or part of the financial year in relation to the new Code provisions.
- The majority of companies have made significant changes to their risk management disclosures to better explain and evidence their processes.
- No company offered a definition for their material controls, and no company reported a significant failing or weakness.
- For the longer term viability statement, three years was the selected lookout period for the majority of companies. No company selected just two years, and five years was the maximum. Over three quarters stated that they used sensitivity analysis, scenario planning or a combination to support the statement.

#### A reminder of the changes

- 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 (Code Provision C.2.1).
- 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 (Code Provision C.2.2).
- The board should monitor the risk management and internal control systems (Code Provision C.2.3).

#### Facts about our survey sample

Deloitte reviewed 17 of the largest operating companies with a September year end whose annual report has been published to date (i.e. excluding investment trusts). The companies and their industries are listed in the **Appendix**.

#### Dealing with the new aspects of the Code

##### Some of the challenges facing boards

- Are we going to be able to report compliance with the new Code provisions for the full year?
- Should the board delegate some or all of these responsibilities and, if so, to whom?
- Is our internal audit function focusing on the right areas?
- Are we demonstrating a joined up risk management and internal control framework through our disclosures?

### **Full compliance with the new provisions of the Code**

No company reported any non-compliance (for even part of the year) in relation to the new Code provisions on principal risks, the longer term viability statement or the monitoring aspects of internal controls.

Seven companies – not far short of half - referred to further developments in their processes and procedures in the coming period. These included specific references to dealing with possible future cyber attacks, the development of a three lines of defence model (see later) and taking forward findings from an external evaluation of their risk management group.

### **The split of responsibility between the board and other committees**

There has been a considerable debate regarding who should be primarily responsible for risk, internal control and longer term viability. Three companies had retained this responsibility at full board level, seven had delegated to the audit committee and five to a risk committee (including the two financial services companies). The remaining two had other specific arrangements in place, one a “Risk Evaluation group” made up of senior management reporting in to the Executive management team and reporting to the board on a regular basis; the other a Global Risk Committee and a Regional Risk Committee (made up of management). The 2016 proposed revisions to the Guidance on Audit Committees clearly state that this is a board responsibility but that the audit committee may play a role in assisting the board to fulfil this function. Risk committees tend to be executive management committees outside of financial services.

### **Auditor reporting**

Under the revised International Standards on Auditing, the auditor is required to include a statement in the audit report as to whether they have anything material to add or draw attention to in relation to any of the disclosures around principal risks, internal control, going concern and longer term viability. As expected, none of the auditors for these first reporters had included any statement in relation to these areas other than to confirm that they had nothing to add or draw attention to.

### **Internal audit**

The disclosures on the work of internal audit were examined to identify examples where there were references to increasing work on risk assessment, controls monitoring or the viability statement. Only one company mentioned the role of internal audit in determining and monitoring principal risks. Several companies reorganised their internal audit functions during the year but these changes were not directly attributed to the new Code provisions. The 2016 proposed revisions to the Guidance on Audit Committees suggest internal audit scope should be reviewed and should look at the principal risks.

### **Linking the disclosures**

Linkage of sections of the annual report is being encouraged to paint an integrated picture and the reports were reviewed for clear linkage between the risk management part of the strategic report, the statement of robust assessment of principal risks, the longer term viability statement, the internal control part of the governance statement, the audit committee report and the auditor’s report.

Just four companies had what we would describe as good narrative linkage, connecting the risk management disclosures and the longer term viability statement to other relevant information such as the business model or strategy, the internal control part of the governance statements and to the principal risk disclosures with sufficient clarity for the reader to understand why those connections were relevant; six showed linkage by providing page cross-references but not always guiding the reader with relevant narrative; and the remaining seven could improve linkage. It is not an easy task, particularly as the complexity of annual reports means that writing of sections is often divided between individuals - good linking requires excellent project management and sufficient review time.

## Risk management

### Some of the challenges facing boards

- Do our existing processes and disclosures reflect a “robust assessment” of principal risks?
- Are we satisfied that our risk identification and assessment process is sufficiently dynamic?
- Is there sufficient focus on the risk culture of the organisation?
- Have we as a board considered our risk appetite and reached an agreed position and approach?

### Evidence of change in the risk management section from the prior year

Nearly all companies changed the risk management sections of their annual reports both in terms of content and structure – almost all had added more description on the risk management process as well as more detail or different detail on principal risks (see below). Some had added diagrams to help the reader to better understand risk management – for instance, a diagram depicting the company’s risk management structure – or a diagram of principal risks, such as a risk heat map.

### Changing principal risks

The vast majority of companies had also made changes to their principal risks – some streamlining the existing categories and some adding in new risks for 2015. New risks reflect today’s board worry list – technology, the extended enterprise and business model challenges - specifically, areas such as information technology and security, supplier failures, tax compliance, failure to implement new strategy and major change projects.

### Risk culture

The FRC’s “Guidance on Risk management, internal control and financial and related business reporting” makes many references to the importance of a sound risk culture throughout an organisation. Six companies made no reference at all to risk culture and nine companies made a brief reference. **Sage Group** (page 38) and **Brewin Dolphin** (page 31) included more than a brief mention.

### Risk appetite

The FRC’s Guidance also makes reference to the board’s responsibility for determining the organisation’s risk appetite. Almost all of the surveyed companies included some reference to risk appetite in their annual report but the extent of those references varied greatly. Eight companies only mentioned risk appetite once or in passing. As expected, both financial services companies in the sample mention risk appetite repeatedly, including in the notes to the financial statements.

Outside financial services, the following companies provided more extensive disclosures on risk appetite:

- **easyJet** – explained that risk appetite is the level of risk the board considered appropriate to accept in achieving easyJet’s strategic objectives and that this is validated by the board on an annual basis. The appropriateness of the mitigating actions is determined in accordance with the board approved risk appetite for the relevant area.
- **Grainger** – provided comment on risk appetite for each principal risk.

### The statement on the robust assessment of principal risks

Code provision C.2.1 calls for a statement that the board has undertaken a robust assessment of the principal risks in the annual report. Thirteen companies in the sample had made this statement clearly; four had not.

The location of the statement varied – seven included it in the strategic report (two within the viability statement); four in the corporate governance statement, one in the audit committee report and one in the management report.

### Gross versus net risk

In almost a third of companies principal risks were considered on a gross (pre mitigation) and a net (post mitigation) basis. The following example from **Grainger** sets out how this approach was used.

**Robust risk assessment**  
 Our systematic risk management approach is designed to identify risks to the business using both a bottom up and a top down approach.  
 Once identified, the impact and probability of risks are determined and scored at both a Gross (before mitigation) and Net (after mitigation) basis. This allows the business to identify those risks which are heavily dependent on internal mitigating controls. When forming this assessment the business considers strategic, market, financial, operational, IT, project and people risks.

Grainger plc Annual Report and Accounts 2015, p26

### Three lines of defence

The three lines of defence model for risk management is regularly referred to in the financial services industry, and six of the sample referred to the three lines of defence model, including both financial services companies. An example from outside financial services is below.

First line of defence	Second line of defence	Third line of defence
Each operating business is responsible for the identification and assessment of risks, understanding the risk return strategy and operating appropriate controls.	Risk & Assurance, supported as appropriate by other functional areas, particularly Legal, Tax and Finance, provides challenge on the completeness and accuracy of risk assessments, reporting and adequacy of mitigation plans.	Internal Audit and the Risk and Audit Committees provide independent and objective assurance on the robustness of the risk management framework and the appropriateness of internal controls.
<p><b>Benefits</b></p> <ul style="list-style-type: none"> <li>• Promotes a strong risk culture and longer term approach to risk management.</li> <li>• Promotes a strong culture of adhering to limits and managing risks exposures in accordance with each business's risk appetite and regulatory environment.</li> <li>• Ownership and responsibility remains close to the operating businesses and their attendant performance.</li> </ul>	<p><b>Benefits</b></p> <ul style="list-style-type: none"> <li>• Challenge across all risk types.</li> <li>• Understand the aggregated risk positions.</li> <li>• Objective oversight and challenge to the business areas and internal control framework used in the first line.</li> </ul>	<p><b>Benefits</b></p> <ul style="list-style-type: none"> <li>• Independent assurance on the system of risk management and internal controls.</li> <li>• Assess the appropriateness and effectiveness of internal controls.</li> <li>• The Risk Committee comprises management and Non-Executive Directors, providing a balance of oversight of the key activities undertaken.</li> <li>• Internal Audit provides assurance to the Audit Committee.</li> <li>• The Risk Committee and the Audit Committee appraise the other on key areas.</li> </ul>

Daily Mail and General Trust plc Annual Report 2015, p51

## The longer term viability statement

### Some of the challenges facing boards

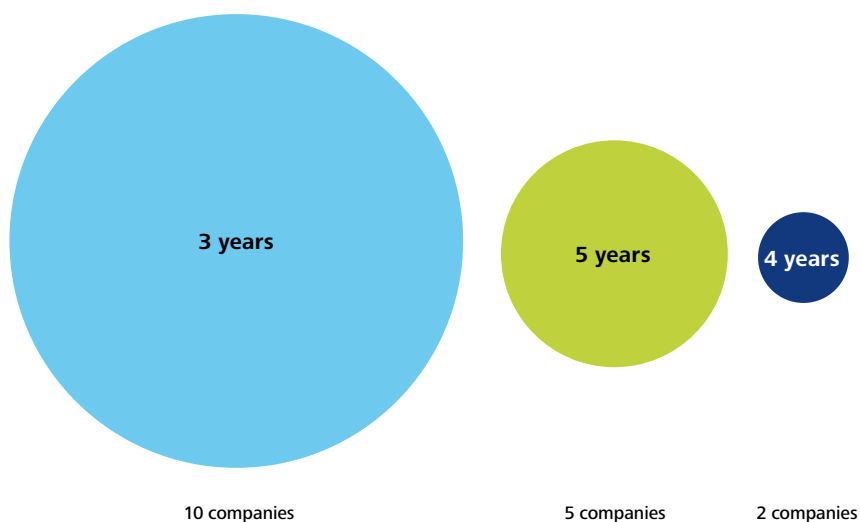
- Should we refer to longer term viability in our preliminary announcement?
- What should our lookout period be and how will we justify that period?
- Where should we put the viability statement in the annual report?
- What analysis do we wish to see to support the viability statement?
- Which qualifications and assumptions are included in the analysis and should be disclosed?

### Reference to longer term viability in the preliminary announcement

It was interesting to see that four companies had made reference to longer term viability in their press release. Of these, three made a brief reference within the discussions on risk management or going concern whereas **Brewin Dolphin** included the full longer term viability statement.

### The lookout period of the longer term viability statement

Figure 1. What lookout period has been used by the 17 companies issued so far?



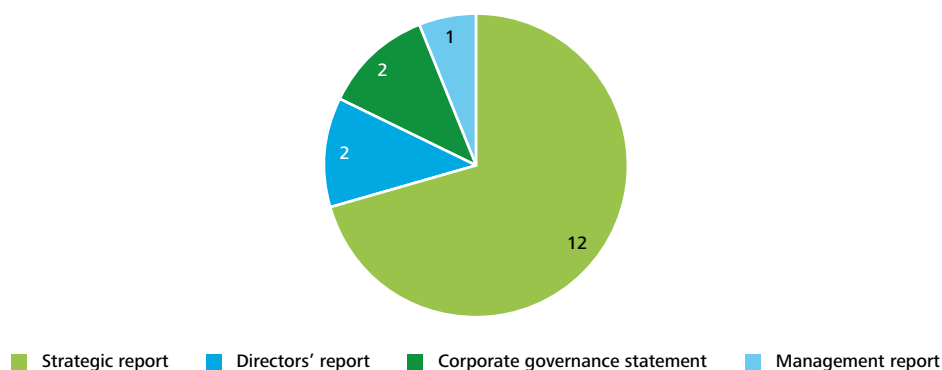
Although the majority of companies chose a lookout period of three years, there have been no clear patterns amongst industry groups. For example, two of the five companies in the travel and leisure industry chose a lookout period of 5 years, the other three a period of 3 years. Both financial services companies have used 3 years.

Of companies that did not use a 3 year lookout period this year, two intend to in future. One used 4 years and explained that they intend to use a 3 year lookout period in the future but in light of future refinancing selected 4 this first year.

### Location of the longer term viability statement

The strategic report was the clear favourite for the location of the longer term viability statement. In most cases, the statement was included in the risk management section alongside the principal risks, although two companies included the statement in the financial review.

**Figure 2. Where did companies locate their longer term viability statement?**



### Connection to the going concern statement

Given the overlap in content over half of the early reporters chose to make a clear link between the longer term viability statement and the going concern statement, two linking the two statements by cross-reference and the remainder just by placing the longer term viability statement adjacent to the going concern statement.

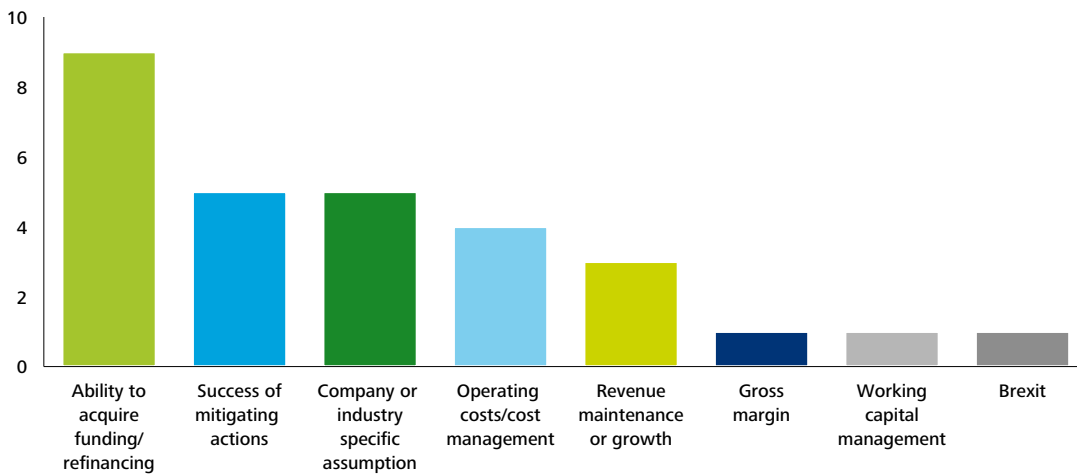
GOING CONCERN	VIABILITY STATEMENT
<p>easyJet's business activities, together with factors likely to affect its future development and performance, are described in the strategic report on pages 1 to 45. Principal risks and uncertainties are described on pages 24 to 29. Note 22 to the accounts sets out the Group's objectives, policies and procedures for managing its capital and gives details of the risks related to financial instruments held by the Group.</p> <p>The Group holds cash and cash equivalents of £650 million and money market deposits of £289 million as at 30 September 2015. Total debt of £504 million is free from financial covenants, with £182 million due for repayment in the year to 30 September 2016.</p> <p>Net current liabilities at 30 September 2015 were £489 million but included unearned revenue (payments made by customers for flights scheduled post year end) of £619 million.</p> <p>The business is exposed to fluctuations in jet fuel prices and US dollar and euro exchange rates. The Group's policy is to hedge between 65% and 85% of estimated exposures 12 months in advance, and 45% and 65% of estimated exposures from 13 up to 24 months in advance. The Group was compliant with this policy at the date of this Annual report and accounts.</p> <p>After making enquiries, the Directors have a reasonable expectation that the Company and the Group will be able to operate within the level of available facilities and cash and deposits for the foreseeable future. Accordingly, they continue to adopt the going concern basis in preparing the accounts.</p>	<p>The Directors have assessed easyJet's viability over a three-year period to September 2018. This is based on three years of the strategic plan, which gives greater certainty over the forecasting assumptions used.</p> <p>In making their assessment, the Directors took account of easyJet's current financial and operational positions and contracted capital expenditure. They also assessed the potential financial and operational impacts, in severe but plausible scenarios, of the principal risks and uncertainties set out on pages 24 to 29 and the likely degree of effectiveness of current and available mitigating actions.</p> <p>Based on this assessment, the Directors have a reasonable expectation that the Company and the Group will be able to continue in operation and meet all their liabilities as they fall due up to September 2018.</p> <p>In making this statement, the Directors have also made the following key assumptions:</p> <ul style="list-style-type: none"> <li>• funding for capital expenditure in the form of capital markets debt, bank debt or aircraft leases will be available in all plausible market conditions;</li> <li>• there will not be a prolonged grounding of a substantial portion of the fleet; and</li> <li>• in the event that the UK votes to leave the European Union, the terms of exit are such that easyJet would be able to continue to operate over broadly the same network as at present.</li> </ul>

easyJet plc Annual report and accounts 2015, p22

**Disclosure of qualifications or assumptions**

The new Code provision (C.2.2) states that directors should draw attention to any qualifications or assumptions as necessary. The vast majority of the early reporters referred to qualifications and assumptions, just four did not. The following graph sets out the range of qualifications and assumptions set out in the disclosures:

**Figure 3. Which qualifications and assumptions have companies referred to in the viability statement?**



**Nature of analysis undertaken**

Code provision C.2.1 asks directors to explain how they have assessed the prospects of the company. All but one of the companies surveyed described the nature of the analysis undertaken. Over three quarters of the first reporters used sensitivity analysis, scenario planning or a combination of the two, showing that companies are taking this exercise seriously. Both the financial services companies in our sample conducted an even more detailed quantitative modelling exercise using their ICAAP processes.

**Clarity on which principal risks have been used in the supporting analysis**

About half of the September reporters made it clear which principal risks had been taken into account when assessing viability. Most of these described the specific risks / scenarios either in words or by cross-reference, one identified two classes of their principal risks (strategic and commercial) which had been used in the analysis and one simply cross-referenced to the whole principal risk statement, suggesting that all principal risks had been considered.

About half of the first reporters made it clear that principal risks had been considered in combination.

The following short example shows both the consideration of principal risks in combination and calls out a specific scenario that had been considered.

The Executive Board has conducted a robust assessment of the principal risks facing the company, including those that would threaten its business model, future performance, solvency or liquidity. Sensitivity analysis is applied to the cash flow to model the potential effects should principal risks actually occur, individually or in unison. This includes modelling the effects on the cash flow of significant disruption to a major destination in the summer season.

### **Responsibility for the work on the longer term viability statement**

The viability statement is a board statement, but the heavy lifting can be delegated to a committee provided it is reviewed by the board. Disclosures indicated that the lead had been taken by the audit committee in about half of the companies and the board in most of the rest.

### **Internal control**

#### **Some of the challenges facing boards**

- Which are our material controls?
- How will we identify significant failings or weaknesses in risk management or internal control systems?

### **Identification of material controls**

Code provision C.2.3 states that the board's monitoring and review should cover all "material controls". None of the September reporters chose to offer a definition for material controls.

### **Significant failings or weaknesses**

None of the companies surveyed mentioned any significant failings or weaknesses in the risk management or internal control systems, although nearly a third indicated how they would identify / determine whether a significant failing or weakness had arisen— an example is below.

The directors completed a review of the effectiveness of the group's system of risk management and internal controls covering all material controls, including financial, operational and compliance controls. The majority of controls operated throughout the year, though some additional controls were implemented during the year. The review did not identify any significant weaknesses in the system of internal control and risk management.

Euromoney Institutional Investor plc Annual Report and Accounts 2015, p39

#### Deloitte view

- The substantial revisions to risk management disclosures show that the new requirements have encouraged renewed focus on the ongoing process of risk management and monitoring of controls.
- We expect that further improvements will be made to company processes, embedding risk management more seamlessly into operations.
- We also expect the scope of internal audit to be reviewed to ensure all principal risks are covered reasonably regularly.

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## Appendix

Companies in our sample	Industry	Outlook period (years)
Aberdeen Asset Management Plc	Financial services	3
Brewin Dolphin Holdings PLC	Financial services	3
Compass Group plc	Travel & Leisure	3
Daily Mail and General Trust plc	Media	4
Diploma plc	Support Services	3
easyJet plc	Travel & Leisure	3
Enterprise Inns plc	Travel & Leisure	5
Euromoney Institutional Investor plc	Media	3
Grainger plc	Real Estate Investment & Services	4
Greencore Group plc	Food industry	3
Imperial Tobacco Group plc	Tobacco	3
Marston's plc	Travel & Leisure	5
The Sage Group plc	Software & Computer Services	5
Shaftesbury plc	Real Estate Investment Trusts	5
TUI AG	Travel & Leisure	3
UDG Healthcare Public Limited Company	Healthcare	3
Victrex plc	Chemicals	5



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