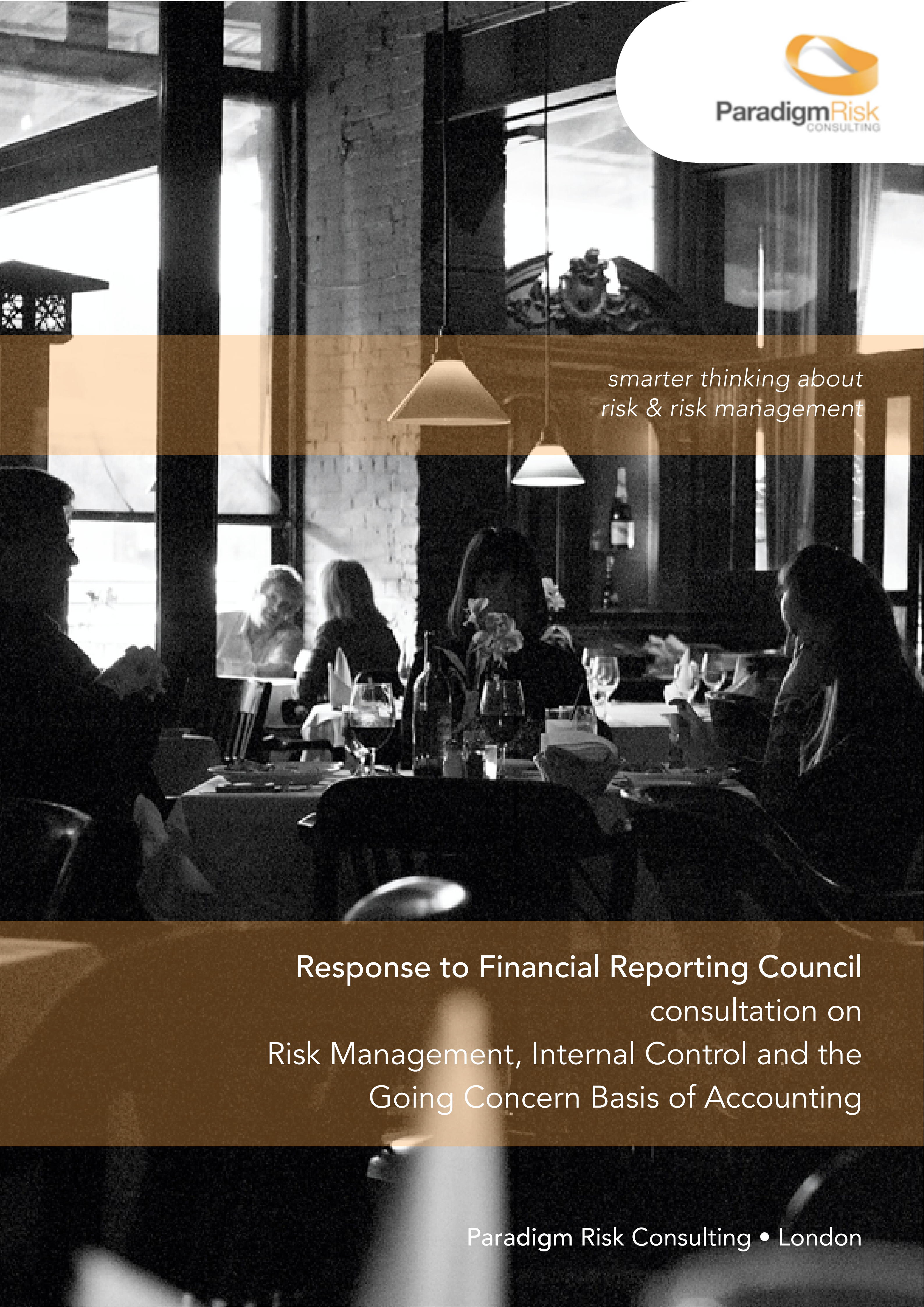

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Response to Financial Reporting Council consultation on Risk Management, Internal Control and the Going Concern Basis of Accounting

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Response to Financial Reporting Council

on the FRC consultation paper

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Executive summary

Introduction

The FRC has moved forward thinking on risk and internal control with the conceptual step of linking analysis of short-term solvency and liquidity risk to the firm's broader routines for analysis and management of risk.

However, such an approach has risks (appropriately enough). In most firms, the vitally important areas of strategy and treasury management – including consideration of solvency and liquidity – and financing the firm as well as technical analysis of physical risks have largely stood apart from corporate considerations of risk through the 'Turnbull process'. There is no empirical evidence that 'Turnbull processes' are useful in a firm; there is ample anecdotal evidence that they are routinely ignored and that the routines underlying extensive areas of corporate risk practice and not contributory to effective management of risk.[1]

By bringing solvency and liquidity considerations in to that ambit, FRC must revisit from first principles the Turnbull process – its objectives, assumptions and effect on firms' management of risk. The FRC's consultation paper Risk Management, Internal Control and the Going Concern Basis of Accounting has not attempted this and, thus, has not succeeded at doing so.

The current consultation paper

The FRC's current consultation paper has failed to capitalize on the insight the linkage of assessment of solvency and liquidity offers or to avoid falling in to elementary traps in thinking about the management of risk in corporate business. Rather than pushing ahead in other areas of thinking about risk, the FRC appears to have chosen to follow 'received wisdom' that has resulted and will continue to result in limited efficacy of most of the corporate risk practice encouraged by its regulatory regime.

Specific problems include but are not limited to the following:

- Guidance by the FRC on risk and internal control is and has been central to framing discourse on corporate risk management in the UK. The FRC appears to have given limited attention to how the network of directors, executives, advisors, consultants and shareholders respond to their guidance, how these responding groups and responses inter-relate or to what behaviours or actions the FRC is attempting to encourage in each of these groups.
- The FRC appears to define risk and uncertainty inconsistently and rather narrowly. There is limited attention to the role of understanding risk and uncertainty in strategy-setting or in terms of the relative risk-taking and risk-holding competencies and capabilities of the firm – the firm's 'competitive advantages' in risk.
- The FRC fails to make explicit that firms can only increase their performance (assuming they are operating efficiently) by increasing the quantum of risk they take. To do so productively, they need to be aware of their comparative advantages in risk-taking. They need to be able to distinguish analytically and practically between those risks in which they hold an advantage which they wish to seek out and those they wish to minimize or avoid. This failure by the FRC continues the 'compliance' feel of earlier guidance by the FRC and predecessors on risk and internal control.
- The FRC document does little to contribute to awareness among firms about the types of risk for which probabilistic analysis is feasible and constructive and how to incorporate in to such analysis subjective assessments of risk, or even that there is an expectation that they should do so.
- In keeping with earlier, Turnbull texts, the FRC mandates *actions* for the board of directors, a body which is and should remain principally *deliberative*. FRC should be clearer in its language and more realistic in its expectations of the role of directors in risk processes and their potential contribution to effecting internal control within firms.

1. See, for example, Tony Cox, 2008. What's wrong with risk matrices? *Risk Analysis*, Vol. 28, No. 2, 497–512

- The FRC consultative document uses critical terms inconsistently resulting in the potential for confusion. At the core of the problem is the conceptualization of risk information; most useful risk information falls below the standards of timeliness, reliability and verifiability expected of accounting information. Much risk information is better characterised as *intelligence*.

- Risk information or analysis based on intelligence is materially different in character and focus from accounting information. In risk, the range of possible outcomes is salient and, particularly, the possibilities of extreme events or outcomes from 'fat tails' of probability distributions. In contrast, accounting information is typically interested in point-estimates and precision. These approaches are fundamentally different and, often, irreconcilable. In order to promote more meaningful attention to risk in firms, FRC needs to acknowledge and consider the corporate implications of these differences for structure and formal settings, analysis and behavior and decision-making.

- In its discussion of risk culture, FRC has strayed outside its areas of competence and has relied on sources of limited knowledge and utility. FRC should be considerably more circumspect in its consideration of risk and culture and the relationship between them. Expecting directors and corporate officers or advisors to offer opinions on culture is fraught with problems and will create significant unintended consequences. At best, it will be ineffective; more likely, it will create adverse consequences that dwarf any possible benefits.

- Directors and managers can *influence* culture; they cannot shape it or direct it or determine it *ex ante*, nor can they observe it objectively. Instead, the FRC should encourage firms to focus on the structures, routines and risk-related behaviours it expects firms to establish and exhibit. These can observed readily and considered meaningfully without advanced training in behavioural observation and analysis. The firm's culture will emerge spontaneously from those behaviours and routines but will be beyond the capability of most observers or participants to define or to direct.

- FRC should not publish checklists of questions relating to risk.

Conclusion

The FRC should accept that its intention to bring analysis of solvency and liquidity within the ambit of firms' broader risk systems invalidates the assumption that the 'Turnbull Guidance' is largely fit for purpose. It has only ever been fit for purpose because that purpose has, since 1999, been mis-specified.

To address these problems, FRC needs to address from first principles the appropriate objectives for firms' risk management and external reporting on risk. It needs to **reframe** management of risk in the corporate setting and to promote meaningful routines of consideration of risk and uncertainty in strategy-setting as well as the **competitive advantages of the firm in risk-taking and risk-holding**. It needs to consider how firms will differentiate those risks they should seek out to contribute to economic performance and those that can only detract from performance. It needs to unpack risk in to its constituents – risk, uncertainty, volatility, complexity, etc. – and to understand which of these the firm can and should consider (and how) within its evaluation of its overall risk-taking and risk-holding preferences (sometimes called 'risk appetite') and its operational and financial capacity to hold risk prudently ('risk tolerance'). At present, none of these things is defined.

Recommendation

We recommend that FRC not issue the current consultation paper without extensive reframing and substantive revision. In its present form, it will simply add cost and disrupt vital routines around analysis of risk for assessment of solvency and liquidity.

Introduction The nature of the problem

By linking routines for assessment of solvency and liquidity with broader routines for corporate assessment of risk, FRC has made a necessary and profound conceptual leap beyond its previous thinking.

However, FRC guidance on risk remains unclear on multiple fronts and, combined with other, related documents, forms a picture that is difficult to follow. The potential for unintended consequences of the proposed Guidance are considerable.

From reading Risk Management, Internal Control and the Going Concern Basis of Accounting ("the November consultation paper" or "the current consultation paper"), the source of the confusion is unclear:

- it may be a problem in relation to FRC's conception of risk or
- it may simply be a problem of clarity of expression or, alternatively,
- it may simply be the requirement to follow the thread of FRC's logic across multiple publications.

The FRC's September 2011 publication Boards and Risk: A summary of discussions with companies, investors and advisers stated (attributed to Baroness Hogg) its conclusions from its consultations:

1. there has been a step change in the Board's focus on risk in the last few years . . . This conforms to the emphasis in the revised Code on the Board's responsibility for strategic risk decision-making.
2. the Turnbull Guidance was still broadly fit for purpose [although] some change was needed to reflect the role of the Board as articulated in the new version of the Code.
3. the approaches and techniques used by boards have been developing rapidly.

We contend that none of these conclusions is sustainable. They come from asking the wrong questions of the wrong people and extrapolating the answers to cover all routines for management of risk in corporate business. Corporate firms' management of risk is, overall, largely effective. However, that may have little or nothing to do with the routines in corporate businesses to respond to the expectations of Turnbull; the two may, simply, be unrelated. Evidently, few major corporate firms fail. However, many firms underperform and could and should take more risk better to earn higher returns sustainably over time. The risk management encouraged by Turnbull may, quite conceivably, diminish the efficacy of firms' risk management and reduce their competitiveness and economic performance.

There has been no empirical analysis of the effect of Turnbull on corporate performance (subjective assessments do not represent any reliable empirical base). However, despite widespread support for the contribution of a broadly similar US framework, COSO ERM, recent academic evidence[2] suggests COSO contributes little or nothing to firms' risk management performance or corporate performance. The same, or worse, may be true of the Turnbull Guidance. Expressions of confidence in its utility among a group of people with a vested interest in its perceived utility are hardly persuasive. As Thomas Paine pointed out, a long habit of not thinking a thing wrong gives it a superficial appearance of being right.

On the contrary, we believe that Turnbull has, by focusing on compliance aspects of risk management, bureaucratized corporate routines for identification and evaluation of risk and has impeded the development of meaningful and effective corporate-wide systems for management of risk. Important risks relating to strategy, treasury and financing the firm as well as technical analysis of physical risks have simply been excluded from that process.

Bringing assessment of solvency and liquidity within the ambit of the firm's bureaucratized risk system necessitates revisiting in its entirety the logic of and effect of Turnbull and its successors. In this response to the FRC's consultation paper, that is what we seek to do.

For ease of reference, in addition to the November consultation paper, we will refer directly in this submission to the following documents:

- The FRC's September 2011 paper Boards and Risk: A summary of discussions with companies, investors and advisers ("Boards and Risk")
- The FRC's August 2013 Exposure Draft: Guidance on the Strategic Report ("Guidance on the Strategic Report")
- The Sharman Inquiry: Going Concern And Liquidity Risks: Lessons for Companies and Auditors: Final Report and Recommendations of the Panel of Inquiry, published in June 2012 ("the Sharman Report")
- The US National Association of Corporate Directors October 2009 paper: Report of the NACD Blue Ribbon Commission: Risk Governance: Balancing Risk And Reward ("Balancing Risk And Reward")
- Report by Michael Mainelli and colleagues, published by CISI, Long Finance and ACCA in July 2012: Confidence Accounting: A Proposal ("Confidence Accounting")

2. Paape, Leen and Roland F. Speklé, 2012. The Adoption and Design of Enterprise Risk Management Practices: An Empirical Study, European Accounting Review, 21 (3), September, 533–564.

Assessment of the consultation paper

By conflating the consideration of the firm's solvency and liquidity assessments with its broader routines for risk, the FRC is encouraging firms to link its prospective financial assessments of failure with its consideration of the broader uncertainties and risks facing the firm. This is wholly appropriate and desirable. First, it forces senior financial officers to consider seriously the linkage between technical consideration of solvency and liquidity and risk and, secondly, it elevates the consideration of risk beyond a compliance activity to a central element of governance and financial management of the firm. As the FRC states, this will

> "make a clearer link between the assessment of business viability risks and the broader risk assessment that should form part of a company's normal risk management and reporting processes." (p.1)

That is desirable. However, in other areas, the consultation paper is beset with problems. The problems with the paper fall, essentially, in to the following categories: problems . . .

- of authority
- of purpose
- of uncertainty
- of subjective assessment of risk
- of the role of company directors
- of information
- inherent in accounting data
- of competence and unintended consequences of the guidance

We will briefly describe each of these, in turn.

Problems of authority

In its discussion of the formation of its position, the FRC indicates that it relies on its Boards and Risk paper. While that paper provided an interesting encapsulation of the views of a narrow range of interested parties – major company chairmen and other NEDs and senior company executives (usually financial executives), it was essentially an assemblage of opinion. The paper was subject neither to consultation nor falsification. The views expressed were, in some cases, highly questionable empirically and in others, simply logically flawed; many or most incorporated a raft of assumptions that were inexplicit and, again, questionable.

References to organizational culture attributed collectively to the Sharman Report and Boards and Risk, must be from the latter document; the word 'culture' does not appear in the Sharman Report. The views expressed thereon in the Boards and Risk paper were profoundly questionable.

Such untested opinions are not a valid basis for regulatory prescription. FRC should exercise extreme care in dealing with issues of culture, for reasons we will discuss below. Such self-reference is disturbing; FRC is an independent regulatory body and should ensure its thinking remains independent of parties it regulates.

Problems of purpose

In the current consultation paper, FRC states its purpose narrowly: to focus on the actions of boards of directors and the content of disclosures by firms in their periodic external reporting.

> "The primary focus of the current guidance . . . is the board's role in establishing and monitoring the effectiveness of the internal control system." (p.3)

This reflects a scope that has beleaguered the Turnbull Guidance since it was originally issued in 1999. While the scope, narrowly defined, reflects the role of the FRC and that perceived by its original authors, its impact reaches far beyond those limited activities. The document, then and now, impacts corporate perceptions of the purpose and function of risk management systems and internal control systems as well as the relation between these systems. The document, then and now, frames the corporate discussion on risk and internal control.

The failure to acknowledge this point or to deal with it explicitly has impeded the development and sophistication, and thus the efficacy, of corporate risk practice since the issue of the original Turnbull Guidance.

Having made the tremendous advance in recognizing the utility of conflating the going-concern consideration with the firm's risk management systems and routines, the FRC's current consultation paper squanders the opportunity to reframe corporate risk systems more comprehensively and constructively. The result is that the current consultation paper is no more likely to lead to encourage improvements in corporate risk practice and risk-taking than previous FRC guidance on risk and internal control.

By limiting the purpose of its document, the FRC is surrendering to the unintended but well understood consequences of flaws in conceptualization and implementation of major UK firms' risk systems and internal control systems. The formulaic and compliance-driven systems of corporate assessment of risk management (as opposed to corporate hedging practice, leverage management and capital planning) observable in the market attest to those flaws. These systems and routines, commonly peddled by 'GRC' advisory practices of accounting firms and other providers, have been shown to be conceptually flawed and, in case after case, to be ineffective. The failure to cast them aside is limiting efficacy of corporate risk practice and corporate profitability.

Again, by interpreting its scope narrowly and producing narrowly-framed guidance against that scope, FRC has abrogated its role in leadership of UK corporate practice in risk management. This lost opportunity reverberates through the economy inhibiting corporate risk-taking and profitability.

Having taken a significant step conceptually in relation to the inclusion of going-concern considerations within the ambit of the firm's broader risk management, FRC should strengthen its statements of expectation of firm's corporate risk practice, outside considerations of the role of the board or periodic reporting. In large measure, it has already taken many of the steps required to do so in other documents. However, inconsistency of language and confusion of terms, compounded by some surviving misconceptions, appear to prevent FRC from finishing the job. We will outline these now.

Problems of uncertainty

In the documents it has produced, FRC uses the terms 'risk' and 'risk and uncertainty' apparently interchangeably. Furthermore, at no time are these terms defined or distinguished. Nor is the relationship between strategy and uncertainty or risk clarified. Inconsistent usage of terms results in a lack of clarity about FRC's intended meaning or, at the very least, potential confusion in the minds of readers of their documents.

However, the nature of confusion appears more profound than simply a semantic difference. Within the scope of financial reporting to which the current guidance document relates, there are a number of areas of uncertainty:

Historic and current uncertainties

- Uncertainty about basis of (ie. assumptions made in) valuations, attributions and assertions used in accounts
- Uncertainty about the comprehensiveness of accounts and potential for errors or deception
- Inaccuracy in historic information due to sampling, observation error, calibration of baselines or mistakes
- Uncertainty about the current state of the world

Uncertainties about the future

- Uncertainties about the future and how it may unfold in relation to known events or assumptions including assumptions about relationships between observed phenomena ("known unknowns") or and tacit assumptions ('unknown knowns'), (collectively, 'epistemological uncertainty')
- Uncertainties about what may happen the future ("unknown unknowns," "unknowables," or 'ontological uncertainties')

In addition, there are ambiguities, complexity and volatility. Each of these falls within the rubric of '*risk*' but each has a different cause, manifests differently and requires, analytically, different consideration. The Sarbanes Oxley Act focused exclusively and encouraged SEC registrants to focus extensively on historical and current uncertainties. To improve performance, firms' risk management needs for focus on uncertainty about the future.

In relation to strategy and the firm's business model – the subject of the Guidance on the Strategic Report, uncertainty is the most relevant of the elements of risk, broadly defined. That is, what assumptions about an uncertain future are incorporated, knowingly or unknowingly, in the firm's business model? How significantly do the known assumptions need to vary before the firm's suffers distress? However, even these questions are not sufficiently profound to encourage consideration of risk in a way that will lead to improved risk-taking.

The nature of the firm is that it places capital (usually a mix of equity and debt) at risk in order to earn a return on that capital that compensates for the time value of money and the risk assumed (*beta*) and may earn some additional, 'unexpected' income (*alpha*, which may be negative).

The only path to improving real economic performance is a secular increase in the income attributable to risk – a higher rate of return for the volatility of the stock relative to the market (*beta*) or a higher average return on the market portfolio. These both necessitate improving firms' efficacy of risk-taking or risk-holding (either of which may include allocation functions). Improved risk-taking requires improving the selection of risks taken relative to the competencies of the firm to manage those risks and excluding or managing more risks from which the firm cannot earn income (including avoidance of opportunity cost) or in which the firm does not have an identifiable competency. That is, improving returns requires the firm to *take more risks in areas where it faces a competitive advantage in risk-taking.* To do so requires the firm to understand where that competitive advantage lies – the nature of the risks it assumes and the firm's relative competencies in assuming or holding those risks.

In short, there is an inseparable relationship between strategy, uncertainty and risk. This is different from and more profound than the presumption of the need for consideration of impact of the principal risk and uncertainties, referred to repeatedly in the Guidance on the Strategic Report paper. Unless and until the FRC understands and communicates to firms and their directors this deeper relationship, consideration of risk will continue to be a 'bolt-on' to strategy at best, more likely ignored in strategic discussions in firms.

If the FRC wishes to encourage firms to improve the efficacy of their risk-taking and risk-holding, the relationship between strategy, uncertainty and risk needs to be specified more clearly. Similarly, the current catch-all expression 'risk' needs to be unpacked and the differences between the different risks – including uncertainty, ambiguity, complexity, volatility and equivocality – elucidated.

The problem of subjective assessment of risk

The current consultation paper makes repeated references to '*risk appetite*' or to

> "the extent and categories of risk which it regards as acceptable for the company to bear."

Again, 'risk appetite' is not explained or defined. The implicit expectation is that firms will understand the metaphor 'risk appetite' and be able to determine how much of each of the "categories of risk" it holds at any one time and its capacity for holding that category of risk. Each of these assumptions is built on a series of further methodological and epistemological assumptions that are, at least, contestable. Here, guidance is limited. Outside an excellent contribution by the US NACD, there are few sources of knowledge for company directors or corporate officers. Where commercial or other providers supply categorizations of risk (and many do), few can provide meaningful information or data on the interactions between risk types or correlations or the conditions under which historic correlations will be compromised.

The FRC's repeated (and inconsistently phrased) exhortations to consider the firm's risk-taking relative to its competencies, risk-holding preferences and capital position require far greater context to be useful. There are risk classes of 'productive risk' in which the firm will have relative advantages; there will be other classes where no level of risk is contributory. The FRC needs to be considerably clearer about what it expects of firms in relation to these deliberations.

The risks that matter are prospective; they relate to an uncertain future in which many relationships are complex; ambiguity is ever-present. Easily calculable volatility is, for most companies, limited to market variables. Therefore, estimation of risk will typically be either probabilistic (as, anyway, are market risks, ultimately) or subjective. Meaningful incorporation of subjective assessments of risk in to a framework of corporate valuation or analysis of expected cash flows requires a level of analytic competence that is far higher than most firms' current settings. Yet, that is precisely the expectation implied by Sharman:

> "stress testing is a powerful tool to lean against the natural optimism of management in thinking about the future success of the business; reverse stress testing can be especially so." (para 15)

We strongly endorse the presumption of the utility of stress testing and reverse stress testing using simulation for all major companies. Firms that oppose such developments should be reminded that they are using other people's money; such a level of diligence is not excessive nor is it unrealistic. However, given the non-market nature and absence of objective probability assessments or price comparators for most corporate risks, considerable care must be taken in developing and interpreting such analyses. Few advisors are well positioned to assist. However, without active and forceful encouragement from FRC, the currently moribund state of corporate-level analysis of risk will persist. That is not and should not be acceptable.

The problem of the role of company directors

It is, as it has always been, a moot point whether it is sensible to mandate *actions* by an essentially *deliberative* body – a board of directors. In the UK model, there are typically multiple executives on a board of directors; it is, however, standard for there to be multiple non-executive directors. Expecting a board to convene to perform an executive function is unrealistic. Phraseology should recognize this.

For example, as written, the proposed Code would read:

> The board should carry out a robust assessment of the principal risks facing the company, including those that would threaten its solvency or liquidity.

It is highly unlikely that such an activity would be *performed* by a board of directors. In reality, directors would require that such an assessment occur and that the results of the assessment be presented to them for consideration and deliberation. Language used should reflect this reality.

Similarly, the requirement that

> The board should monitor the company's risk management and internal control and, at least annually, carry out a review of their effectiveness, and report to shareholders that they have done so,

is unrealistic. It is both reasonable and realistic to expect the board to require that management develop, implement and operate appropriate systems of and routines for the anticipation and management of risk and for internal control and to review or direct that reviews occur of their effectiveness. Again, the language should reflect the reality.

As a separate point, the proposed Code text reads:

> The monitoring and review should cover all material controls, including financial, operational and compliance controls.

The focus on financial, operational and compliance controls is unhelpful. Corporate systems and routines for consideration of risk should focus initially at the level of strategy; operations are put in place to effect strategy; sufficient capital is required to finance the operations and risk inherent therein; financial operations are necessary to support operations and compliance is necessary to obey relevant laws and regulations.

As stated, the sentence does not follow from the preceding sentence – there is no reference to the monitoring and review of systems and routines for management of risk; if the presumption is that management of risk is a subset of a broader system of control, that presumption should be made explicit.

The language of proposed Code provision C.2.2 will have the effect of limiting review of the firm's systems of control from where they matter most: the development and execution of strategy and monitoring of performance against assumptions in the firm's strategic plans; sufficiency of capital and quasi-capital and the efficiency of operations. By focusing on financial controls initially, FRC reinforces the importance of these relative to other areas of control attention. This focus is unhelpful.

The problem of information

Under section 5 of the Draft Guidance appears the following statement:

> 31.The risk management and internal control system encompasses the policies, culture, processes, systems and other aspects of a company that, taken together:
>
> - facilitate its effective and efficient operation by enabling it to respond appropriately to principal risks and significant control failures, to identify emerging risks and to safeguard its assets;
> - reduce the likelihood of poor judgement in decision-making; risk-taking that exceeds the levels agreed by the board; human error; control processes being deliberately circumvented by employees or others; or management overriding controls;
> - help ensure the quality of internal and external reporting. This requires the maintenance of proper records and processes that generate a flow of timely, relevant and reliable information from within and outside the organisation; and
> - help ensure compliance with applicable laws and regulations, and also with internal policies with respect to the conduct of business.
>
> 32.A company's system of risk management and internal control will include: control activities; information and communications processes; and processes for monitoring its continuing effectiveness.

This passage creates, or, more accurately, *perpetuates* a series of misconceptions. First, the document uses the terms 'system' and 'systems' inconsistently; sometimes it refers to the 'internal control system', sometimes to 'risk management and internal control system' and at other times to the 'risk management and internal control systems' in the plural. While this inconsistency may simply be an artifact of drafting, it may also reflect a deeper uncertainty of what such a system is or such systems are. FRC needs to clarify, for itself, what it means by these terms and use the terms consistently throughout the document.

Under the second bullet point, "control processes being deliberately circumvented by employees or others; or management overriding controls" are the same point.

The terminology of paragraphs 31 & 32 encapsulates a misconception at the core of the FRC's guidance. As portrayed by the FRC, consideration of risks in decision-making is an orderly process of assembling objective and verifiable information and presenting it to decision-makers for rationalistic processing to result at a correct judgement. While that rationalist, objectivist model is appropriate in very limited circumstances, risk management more usually involves incomplete information, inference and reliance on managerial interpretation and judgement, beset by biases and assumptions, deploying heuristics extensively. The two visions – the idealized, FRC view and realist view – are not compatible.

The heart of the problem is the characterization of risk information:

> ". . . This requires the maintenance of proper records and processes that generate a flow of timely, relevant and reliable information from within and outside the organization [and, at para. 32] . . . control activities [and] information and communications processes . . ."

Where objective information is available, it should, of course, be sought and used where cost-effective to do so. However, such instances will be rare: there will not be 'proper records' or 'timely, relevant and reliable information' available. Such information as is available will be partial and its relevance a matter of inference rather than direct reference. The information may be reliable but, often, the stability of the relationship between the observed variable and the variable of interest will be uncertain. In these circumstances, it may be more relevant to talk of *intelligence* rather than the information used in historic accounting treatment.

Problems of competence and unintended consequences of the guidance

One of the recommendations of the Sharman Inquiry was for the FRC to enhance its monitoring of and response to corporate failures and near misses. Learning from mistakes is essential. The FRC should consider more carefully the unintended consequences of previous guidance on risk management and internal control.

Since the original Turnbull Guidance in 1999, that document and its successive revisions have had an enormous influence on corporate risk management practice; that influence has not been uniformly positive or benign. The approach adopted, which was in accord with the COSO initiatives in the US (and adopted language therefrom), focused management of risk as a control activity relating to preparation of the firm's statements of account. This centred responsibility for corporate risk management and internal control around financial control and internal audit. This association was reinforced following the spectacular failures in the US of Enron and WorldCom and other corporate failures involving irregularities in financial reporting and the subsequent Sarbanes-Oxley Act in 2002. The result was that firm-level risk management became the corporate preserve of finance directors (who, mostly, oversaw treasury functions, reinforcing the association).

However, to be effective, corporate risk management requires a different focus from accounting or financial control. First, as noted, it must involve consideration of strategy and be involved in consideration of strategy. Secondly, it is prospective not retrospective as is accounting (a point made explicitly by Sir David Walker in his 2009 review of corporate governance in the banking industry). Thirdly, risk management requires understanding the probabilities associated with the range of possible outcomes for any variable rather than calculating values based on point estimates. In risk management, the range is pertinent as are the skewness or the kurtosis (peak/tail shape) of the probability distribution of outcomes; accounting requires adopting a single value for any variable. The differences analytically and behaviourally are tremendous. *Confidence Accounting: a Proposal*, referred to above, represents a recent proposal to reconcile the competing approaches by reducing reliance on spurious accuracy in accounting.

This focus has reinforced and been reinforced by the reliance of senior corporate financial officers on practice firms for advice; these firms have responded, expanding significantly their advisory services in risk despite having little or no defensible claim to expertise therein. This symbiosis has impeded the development of corporate risk management practice materially since 1999. FRC needs to recognise the network of advisory relationships its Guidance encourages and understand the implications of those relationships.

'Behind enemy lines': risk culture

Despite this history, and the Sharman Inquiry exhortation to learn the lessons of history, the FRC's current consultation paper is set to repeat the error. The paper makes several references to risk culture, beginning on page 1:

> "The board must determine . . . the desired risk culture within the company."

Later, in relation to responsibilities, the paper states:

> "The board's specific responsibilities in relation to risk include [inter alia] ensuring that an appropriate risk culture has been instilled throughout the organization. . . " (Guidance, para. 19)

The paper states that

> "the annual assessment should, in particular, consider [inter alia] the culture of the company and the extent to which the desired culture has been instilled."

With the exception of limited reference at para. 24 of the Guidance document and linking culture to incentives at para. 34 thereof, FRC provides no indication of how it expects these requirements to be met.

The impetus behind the inclusion of risk culture in the FRC's guidance document comes, as noted above, from interviews with corporate directors and senior financial officers during the FRC's earlier consultations, published in Boards and Risk. That document's initial summary finding states:

> "The Board's overall responsibilities included determining the company's approach to risk, setting its culture, risk identification, oversight of risk management, and crisis management,"

and on the following page:

> "Good corporate culture was widely seen as essential to good risk management, and in this respect the Board needed to set the tone at the top. Boards were becoming more proactive in seeking to assure themselves about the risk and control culture in the company."

In terms of the role of the Board, that document states:

> "Participants identified a number of different elements to the Board's responsibilities for risk. They were [inter alia] setting and instilling the right culture throughout the organization."

As noted, the Sharman Inquiry did not use the word 'culture' in its final report.

In relation to organizational culture, John Kotter of Harvard Business School stated in an interview in Forbes in 2012:

> "Here is the problem: First, virtually no one clearly defines what they mean by 'culture', and when they do they usually get it wrong. Second, virtually no one has read the original research that shows why culture – when clearly defined – is so important, how it is formed, and how it changes."

These criticisms appear valid in relation to the FRC's current consultation paper. Relying on the opinions and assumptions of a group of directors and financial executives who are probably untrained in behavioural disciplines relating to culture is unhelpful. Worse, FRC has not studied its own history. Without the skills needed to assess culture, risk, audit and compliance personnel will turn to advisors; quite possibly to the chartered accounting firms who claim expertise in risk and audit matters. They will, quite naturally, respond to the demand by providing services. They, too, however, cannot define culture and have not read the original research. They, too, do not know what they do not know.

The FRC cannot explain organizational culture, nor can it define what attributes of culture are contributory to performance in management risk and which are not. Nor can the advisors to whom major UK companies routinely turn for advice in 'governance' matters. Nor can the internal auditors required to offer comment on whether or not the firm has a culture that is conducive to effective management of risk. That is not surprising; analysis of culture is an observational and behavioural discipline of tremendous subtlety and complexity.

Famously, in 1952, American anthropologists Alfred Kroeber and Clyde Kluckholn[3] identified 164 different definitions of culture. It is unlikely the number of definitions has declined in the intervening sixty years. With so many different definitions available to choose from, which is the appropriate definition? With that question unresolved, the attention to culture, especially in relation to analysis of corporate failure and failures (including, most recently, the global financial crisis and misbehavior in banks) has proliferated. The UK's parliamentary Treasury Committee report on Barclays and the LIBOR scandal referred to 'culture' 50 times; the word was used 96 times in oral evidence.[4]

3. Kroeber, A. L. and Clyde Kluckhohn, 1952. Culture: A Critical Review of Concepts and Definitions, Papers of The Peabody Museum Of American Archeology and Ethnology, Vol. XLVII, No. 1, Cambridge, MA: Harvard University
4. For a fuller discussion of this report and its analysis of culture, refer to the 2012 Paradigm Risk briefing paper Regulation, risk & culture: will we never learn? The truth about Neil Armstrong, Barclays, LIBOR, risk & culture available from the Paradigm Risk Consulting website at www.paradigmrisk.com/publications

However, as Canadian academics Yvan Allaire and Mihaela Firsirotu pointed out in a seminal article[5] on organizational culture in 1984,

> "this notoriety may turn a complex, difficult but seminal concept into a superficial fad, reduce it to an empty, if entertaining, catch-all construct explaining everything and nothing! Indeed, with a few notable exceptions, invocations of culture are not followed by any elaboration. It is presumed that the word 'culture' is a stenographic cue for 'values, norms, beliefs, customs' or any other such string of convenient identifiers chosen among the vast assortment of definitions available in a random pick of texts from cultural anthropology."

The absence of definition of culture or risk culture in the FRC's work suggests that description may be apposite.

The expectation that corporate officers or consultants may be able to analyse or assess their own culture is similarly flawed. In her seminal analysis of the *Challenger* incident, Columbia University sociologist Diane Vaughan (an advisor to the NASA's investigation of the *Columbia* explosion) has written:

> "In the *Challenger* incident, the organization culture was much more complicated and its effects on decision-making more subtle and hard to detect than even insiders realized. As members of an organization, we are sensitive to certain aspects of culture, resisting it, but others become taken for granted, so that we unquestioningly follow its dictates without realizing what the culture is, how it is operating on us, or how we both use and contribute to it."

The problem has long been identified. Kroeber and Kluckholn (they of the 194 definitions), for example, wrote in 1952:

> "The analysis of a culture must encompass both the explicit and the implicit. The explicit culture consists in those regularities in word and deed which may be generalized straight from the evidence of the ear or eye. The implicit culture, however, is an abstraction of the second order. Here the anthropologist infers least common denominators which seem, as it were, to underlie a multiplicity of cultural contents. Only in the most sophisticated and self-conscious of cultures will his attention be called directly to these by carriers of the culture, and then only in part."

Without advanced training in and experience of behavioural analytic techniques, corporate officers and consultants cannot hope to assess culture meaningfully; the exhortation by the FRC to do so cannot contribute usefully to corporate management of risk or to improving the effectiveness of corporate control routines. As in earlier, ill-thought-through 'Turnbull' texts, unintended consequences of relying on external advisors with a different and incompatible skills set will result in assessment routines that are bureacratised and ultimately meaningless that simply add cost and deflect worthwhile organic development of capabilities in firms.

Not all 'professional' contributions to the fields of risk and culture have deserved that epithet; most have been anything but professional. The much-referenced Institute for International Finance document[6] referring to risk culture referred only scantily and superficially to any informed understanding of culture or organizational culture. The Institute of Risk Management's 2012 paper[7] on the topic was riddled with error and supposition and (no-doubt accidental) mis-reading and mis-representation of earlier academic research. These documents are not sound bases for assuming that risk culture can meaningfully be assessed, least of all measured.

The fetish for quantification has, naturally, made its way to culture. Many advisors have advocated measurement of risk culture, including in the IRM publication. Most if not all make the heroic and wholly unsustainable assumption that individual psychometric instruments (which may be completely valid) are additive; they simply are not. Any prescription for change emerging from use of such instruments or 'target cultures' are likely to be fraught with unintended consequences. British/Canadian organizational theorist Gareth Morgan[8] refers to these consequences:

> "To the extent that the insights of culture are used to create and Orwellian and world of "corporate newspeak", where culture controls rather than expresses human character, the metaphor may prove quite manipulative and totalitarian in its influence. The message: observer beware. There is often more to culture than meets the eye and our understanding is a usually much more fragmented and superficial than the reality itself. [However,] many management theorists view culture as a phenomenon with clearly defined attributes. Like organisational structure, culture is often reduced to a set of discrete variables such as values, beliefs, stories, norms, and rituals that can be documented in manipulated in instrumental way."

5. Allaire, Yvan and Mihaela Firsirotu, 1984. Theories of organizational culture, Organization Studies, 5: 193–226.
6. Institute of International Finance, 2009. Reform in the financial services industry: Strengthening practices for a More Stable System, The Report of the IIF Steering Committee on Implementation, IIF, December; see especially Appendix III.
7. Hindson, Alex et al., 2012. Risk culture under the microscope, London: Institute for Risk Management, October
8. Morgan, Gareth, 1997. Images of Organization, Thousand Oaks, CA: Sage Publications

Looking at the problem of risk culture directly, a 2013 research report by Michael Power of LSE and colleagues[9] described risk culture as a mix of formal and informal processes:

> "The former are easy to observe. The latter are harder to observe since they involve a myriad of small behaviours and habits which in the aggregate constitute the state of risk culture at any one point in time."

They went on to observe that organisations may have multiple risk cultures and that risk cultures may be "trans-organisational". As they point out, the discourse about risk culture is, in reality, often about something else:

> "The most fundamental issue at stake in the risk culture debate is an organisation's self-awareness of its balance between risk-taking and control. It is clear that many organisational actors prior to the financial crisis were either unaware of, or indifferent to, the actual trade-off or risk profile of the organisation as a whole. A combination of control functions being ignored or fragmented and of revenue-generating functions being given star status rendered the actual trade-offs involved in this balance institutionally invisible, both internally and externally, until disaster struck.
>
> "For this reason, the prescriptions arising from our research essentially point towards recovering the organisational capability to make visible, to understand, and to accept or change the actual control-risk trade-off."

The authors conclude:

> "there is a need for financial organisations to be aware of the many trade-offs we have identified . . . to monitor these trade-offs, and to make explicit decisions about them where possible, rather than allowing them simply to happen to the organisation. When it comes to risk culture, our report suggests that it is not only the level of risk-taking that was deviant in many organisations. It was also the lack of this organisational self- knowledge and the authority to act upon it."

Rather than nebulous prescriptions relating to the specification of a "desired risk culture," or "an appropriate risk culture" or a "desired culture" which cannot meaningfully be specified *ex ante* or measured *ex post*, the FRC should concentrate on the structures, routines and risk-related behaviours it expects firms to establish and exhibit. These are both potentially meaningful and impactful. Introducing 'culture' in to the debate, even as a 'short-hand' simply complicates an already difficult area.

9. Power, Michael, Simon Ashby & Tommaso Palermo, 2013, Risk culture in financial organisations: a research report, LSE Centre for Analysis of Risk and Regulation, September

Appendix D

This Appendix to the Guidance document contains a relatively innocuous and suerpficially sensible series of questions relating to the range of issues discussed in the Guidance. What is not sensible is the idea of presenting such a set of questions in the first place.

A list of anodyne questions to which many responses can be 'yes' or 'no' is of very limited benefit. Providing such a list in the Guidance suggests that, if a firm can answer, however cursorily, most of the questions, they will have 'ticked the box'. This thinking has predominated in the debate over risk as framed in discussions of governance, risk and compliance and has done incalculable damage. It has played in to the hands of practice firms whose people typically have very limited skill sets in these areas (except, possibly, in compliance) and has resulted in compliance- or conformance-driven thinking predominating in an area that is, or should be, critical to corporate performance.

Explicit consideration of such a list by a board of directors is unlikely to result in meaningful dialogue or an improvement in the firm's understanding of the relationship between strategy and uncertainty and risk or the focus or performance of a firm's risk management routines. On the contrary, it is likely to allow and even encourage directors to avoid the difficult but meaningful questions about risk and to result in an unjustifiable sense of confidence in the efficacy of the firm's risk management. No such list should be included or offered by FRC.

Were such a list to be required, a much more meaningful and provocative set of questions could readily be compiled that would result in more constructive debate and dialogue within a board and between the board and executives of the firm. Among the current question set there are some that are simply misconceived and far too many that can result in perfunctory answers.

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