BY
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Some Recent Corporate Governance Reports: a Focus on Risk

Gary Martin provides some insights into how corporate governance matters have been dealt with since the 'global financial crisis'.

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Introduction

The autumn of 2013 marked the fifth anniversary of what has become known as the 'global financial crisis', events precipitated by the filing for bankruptcy, on the 15th of September 2008, of Lehman Brothers in the United States. This event was described at the time as 'one of the worse banking collapses in history'[1]. What happened in the autumn of 2008 was preceded by the 'credit crunch' of 2007; taken together, they have become seared on the collective memory of the global economy.

Moreover, we continue to live with the consequences of these paradigm shifting occurrences years later. And, whilst there were many and various reasons behind the causes of both, the events of 2007 and 2008 prompted a closer look at corporate governance, a particular focus being trained on risk, and how it was managed.

The purpose of this brief article is to present some insights into how these matters have been dealt with, in particular focusing on documents emanating from the Financial Reporting Council (FRC) in recent years.

Risk, the credit crunch and the global financial crisis

In reviewing some of the many reports published in the wake of the credit crunch and subsequent global financial crisis, it becomes apparent that risk management (or, it could be argued, its mismanagement) was a central issue. In an insightful paper on the credit crunch, published in 2008[2], the Association of Chartered Certified Accountants (ACCA) stated that it, at that time, believed *'excessive short-termism, coupled with a lack of accountability both within financial institutions and between management and shareholders, is at the heart of the problem'* (2008: 3)[3], before going on to note a number of key and secondary factors that lay at the root of this observation. The key factors all involved risk in some shape or form, in particular that there had been a lack of: awareness surrounding the interconnectedness of risks; alignment of interest between remuneration arrangements in financial institutions which focused on the short-term, not consistent with the long term interests of owners; status afforded to the risk management units within banks; and effective risk reporting. In their analysis of the global financial crisis of 2008, the Organisation for Economic Co-operation and Development (OECD)[4] noted that (2009: 8) *'perhaps one of the greatest shocks from the financial crisis has been the widespread failure of risk management',* noting further that *'risk was not managed on an enterprise basis and not adjusted to corporate strategy'*. These issues were exacerbated by: a lack of appreciation about the role risk managers played in effecting corporate strategy; and ignorance on the part of boards about the risk their organisations faced in some cases. Closer to home, the title of the report prepared by the Commission of Investigation into the Banking Sector in Ireland[5] gives a clear indication of the role risk played in the events it considered: Misjudging Risk.

Some of the corporate governance policy responses

As can be seen from the sources above, there can be little doubt about the role risk management, or its mismanagement, played in the events that unfolded in 2007 and 2008. There have been many policy responses to these events around the globe; however, given the brevity of this article, effort will be concentrated on some of the major initiatives taken forward by the FRC in recent years.

1 Quinn, J. (2008), Lehman Brothers files for bankruptcy as credit crisis bites, The Daily Telegraph, 15 September.

2 ACCA (2008), Climbing out of the Credit Crunch, London: ACCA.

3 ACCA (2008), Climbing out of the Credit Crunch, London: ACCA.

4 OECD (2009), Corporate Governance and the Financial Crisis: Key Findings and Main Messages, Paris: OECD.

5 Commission of Investigation into the Banking Sector in Ireland, Misjudging Risk: Causes of the Systemic Banking Crisis in Ireland, Report of the Commission of Investigation into the Banking Sector in Ireland, Dublin: Stationery Office.

The most significant development has been the publication of the UK Corporate Governance Code, first issued in 2010, following a major review of the Combined Code in 2009; it was further updated in 2012. The Code was adopted by the Irish Stock Exchange, in conjunction with its development of the Irish Corporate Governance Annex; the Annex is based on *'recommendations arising from the report commissioned by the Irish Stock Exchange and the Irish Association of Investment Managers in early 2010 which provide a valuable addition to the corporate governance regime in Ireland'*[6].

Returning to the UK Corporate Governance Code and issues relating to risk management, the main principle[7] of the Code states that: *'The board is responsible for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives. The board should maintain sound risk management and internal control systems.'* Furthermore, it goes on, in its supporting provisions, to state that the effectiveness of the risk management and internal control system should be attested to by the board on an annual basis. As can be seen with some of the perceived board deficiencies noted in a number of cases in the OECD report with regard to risk, there is an emphasis in the UK Code to deal with this particular shortcoming. Indeed, the FRC has helpfully prepared a range of other reports[8] to help boards and related committees apply the Code. These include publications dealing with: the role of audit committees; board effectiveness; going concern and financial reporting; and risk management and internal control. As part of this latter strand of documents, a useful report has been published entitled 'Boards and Risk'[9]: as the FRC points out, this is not guidance, but instead a summary of discussions with a range of relevant participants to determine how boards were actually approaching issues relating to risk management and internal control.

Consequently, it is made available for the purposes of assisting others in determining how they might most effectively address risk within their own companies. In developing this work more recently, the FRC, in November 2013, launched a consultation entitled *'Risk Management, Internal Control and the Going Concern Basis of Accounting: Consultation on Draft Guidance to the Directors of Companies applying the UK Corporate Governance Code and associated changes to the Code'*[10], part of which involves seeking views on issues relating to risk management and internal control: these specific proposals, in the words of the FRC (2013: PN 094), *'aim to raise the bar for risk management by boards and communication to the providers of risk capital about the risks faced by companies in which they invest and how they are managed or mitigated'*.

Given the centrality of effective internal control arrangements in securing successful risk management outcomes, it is worthwhile reviewing some of the many international documents relating to best practice in internal control arrangements. One such report was published by the International Federation of Accountants[11] in 2013: it argues that the 'right kind' of internal controls can be beneficial for organisations, in that: they enable opportunities to be taken; and allow for effectively dealing with threats to the organisation, in the process conserving time, effort, financial resource and, ultimately, value. These are all key issues for boards to consider when dealing with risk: effectively addressing internal control issues, this report further argues, creates competitive advantage for the organisation. However, as the FRC UK Corporate Governance Code[12] is clear to point out (2012: 2), *'The Code, however, is of necessity limited to being a guide only in general terms to principles, structure and processes. It cannot guarantee effective board behaviour because the range of situations in which it is applicable is much too great for it to attempt to mandate behaviour more specifically than it does. Boards therefore have a lot of room within the framework of the Code to decide for themselves how they should act'*. The upshot of this observation is that, whilst structures, systems and processes for ensuring effective corporate governance arrangements are important, they are only part of the process; what is also of equal importance are the quality and standard of behaviours that underpin structural governance arrangements, an issue boards need to be alive to.

In the context of risk management and behavioural issues specifically, it is thus crucial to consider the role played by the risk culture of the organisation. An informative document[13] relating to this issue was published by the Institute of Risk Management in 2012; this provides a valuable resource for boards seeking to better understand behavioural issues in corporate governance, so as to ensure they are consistent with the needs of the risk management system they oversee in their organisation. The document helpfully notes[14] that (2012: 7): '*Culture is more than a statement of values – it relates to how these translate into concrete actions'.* An awareness of such issues is of crucial importance to the contemporary board of directors, particularly if they are to avoid some of the pitfalls that led to the events of five years ago.

6 Available at: www.ise.ie
7 Financial Reporting Council (2012), UK Corporate Governance Code, London: Financial Reporting Council.
8 Available at: http://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Corporate-Governance-Code/Guidance-for-boards-and-board-committees.aspx
9 Available at: http://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Corporate-Governance-Code/Guidance-for-boards-and-board-committees.aspx
10 Financial Reporting Council (2013), Risk Management, Internal Control and the Going Concern Basis of Accounting: Consultation on Draft Guidance to the Directors of Companies applying the UK Corporate Governance Code and associated changes to the Code, London: FRC.
11 IFAC (2013), International Good Practice Guidance - Evaluating and Improving Internal Control in Organizations: Executive Summary, New York: IFAC.
12 Financial Reporting Council (2012), UK Corporate Governance Code, London: Financial Reporting Council.
13 Institute of Risk Management (2012), Risk culture Under the Microscope: Guidance for Boards, London: Institute of Risk Management.
14 Institute of Risk Management (2012), Risk culture Under the Microscope: Guidance for Boards, London: Institute of Risk Management.