Risk and the Strategic Report

"Risk is a word that refers to the future, it has no objective existence. The future exists only in the imagination" – Professor John Adams, UCL

The Strategic Report, which replaces the Business Review, under the Companies Act amendment 2013, marks a significant change in the way risk is to be reported. The law now addresses current government policy: "*to make companies more accountable to their shareholders and the public*" through three key changes which can be summarised below.

1 Linking Risk and Strategy

Individually Risk and Strategy have been reporting requirements (Risk since the 2006 Companies Act and Strategy since the 2010 Corporate Code update). The 2013 Companies Act amendment for the first time links these two with the aim: "*to provide insight into the entity's main objectives and strategies, and the principal risks it faces and how they might affect future prospects*".

It is right that both strategy and risk are linked in narrative, yet until recently there has been an unhelpful separation in many Annual Reports. Strategy reporting has emphasized future growth opportunity, while risk reporting listed potential threats alongside control systems designed to mitigate them. The intention was to reassure regulators and investors.

This misrepresents risk, which is ultimately about future uncertainty (opportunity as well as threat) and future events which might impact business performance. Strategy is about future direction and the route chosen to achieve pre-determined goals or business objectives. Both strategy and risk are bedfellows which together assume an unknown future.

Risk management as a discipline has become fixated on control, largely because this is a proven method of reducing uncertainty. However as the future itself is uncertain, risk management cannot deliver certainty, only the illusion of control. Investors accept risk as a trade for reward and would be wary of any investment devoid of risk; they expect risk within the strategic report to be an honest explanation of the odds on securing a return.

2 Strategic not Operational risk

The 2006 Companies Act introduced the term *principal* risk and the 2010 Corporate Code update the term *significant* risk, each leaving room for interpretation by the regulator. The result has been a mixture of specific business risks: Operational risks which are largely controllable and predictable and for which control systems can de designed; Market risks which are largely uncontrollable and far less predictable for which no controls exist.

Few reports to date address the issue of Strategic risk. These are the risks inherent in management decisions about strategy and direction, assumptions in the business model fundamental to the success of the business. These tend to be boardroom risks shared by the executive. These often evade close scrutiny by the CRO, Risk Committee or NEDs.

Strategic risks can include culture, sustainability, reputation, corporate behaviour and stakeholder value alignments but to date very few organisations report on these within the risk section (within the Financial Services sector the new Financial Conduct Authority has introduced the concept of Conduct risk but this could be seen as a Compliance risk).

The new Strategic Report will require some explanation of Strategic risk. The Corporate Code update in 2012 required 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*", however the 2013 Strategic Report now requires reporting of the principal risks relating to this.

3 Risk Governance not Risk Management

Risk governance is a board responsibility as distinct from risk management which is a functional activity. Governance requires the setting of culture, appetite and tolerance as well as the oversight of a risk management function.

In 2011 the FRC produced a report entitled 'Boards & Risk' which set out where it believed companies were failing to report risk adequately. The FRC considered three key aspects of risk reporting which can broadly be headed Approach, Interpretation and Explanation. These three form a very useful guide for the presentation of risk within the new Strategic Report.

Approach

"*The Board is responsible for determining the approach to risk, setting its culture, risk identification, oversight of risk management, and crisis management. It is a shared responsibility*".

Interpretation

"*The Board needs to agree its appetite or tolerance for key individual risks; to understand the company's exposure to risk and how this might change. Companies should indicate to shareholders when and to what extent they believed exposure to risk was changing*."

Explanation

"*Qualify why the reported risk is significant, why it represents a threat and what the organisation is doing to control this. Explain how readers will know when a risk ceases to exist and explain contingent factors that increase or decrease this risk*."

For the Strategic Report there are some key pointers here which are intended to help clarify risk for investors: the *dynamics* can increase or decrease, as can the *exposure* level, so it is possible for a risk to decrease but an organisation's exposure to it to remain constant. The key requirement is to explain the circumstances for, and implications of, such changes.

The inclusion of contingent factors should encourage risk explanation to consider the *inter-connectivity* and *inter-dependence* of risks, many of which are not discrete or homogenous. The 'law of unintended consequences' is also a useful reminder in reporting risk and together this checklist from the FRC should help define how the term *principal risk* should be applied.

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