Black Swan or simply poor insight?

Consider the role of the Non-Executive Director and the relevance of gaining appropriate assurance as an aid to attainment of corporate objectives.

It seems that a common feature of risk management systems is to focus on a level of residual risk with which executive management is currently engaged; all too often none of the declared risks are at a level which would cause disruption that would be regarded as sufficiently severe as to threaten the existence of the organisation. Yet discussions, outside of the agenda often consider the ‘what if’ scenario.

Why so, when the whole purpose of a transparent risk management process is to enable appropriate discussion at Board level regarding the fulfilment of the key roles and responsibilities of the directors. A summary of these would surely reflect as being in any code to:

Develop strategic direction	Ensure compliance with governing documents
Establish and monitor policy	Ensure accountability
Compliance with law	Maintain effective board performance
Promote the success of the organization	Proper fiscal oversight
Respect role of staff and Set up employment procedures	Select and support the CEO

In order to demonstrate effective corporacy and understanding of the key business issues and therefore compliance or achievement against each of these criteria, there is a need to develop a strong governance framework in which directors recognise the ambition of the corporate strategy and as a consequence the potential impact of risks that the organisation faces – these then define the core responsibilities of Non-Executive and Executive Directors in terms of providing assurance and therefore demonstrating effective governance at Board level. Such analysis cannot therefore simply focus on what is causing a problem but must recognise what could give us a problem; otherwise it is conceivable that anything which we chose not to consider in terms of impact and likelihood should be classed as a black swan – supposedly beyond what we as a board could possibly have been expected to foresee.

The term "Black Swan Theory" was popularized by Nassim Nicholas Taleb in his book "The Black Swan" in which he defines the term to mean "events that have a major impact on the course of history”. In risk management terms, the meaning has been taken to be an event that is nearly impossible to predict and is unexpected in even the most detailed and carefully calculated of probability models to occur.

So are events such as the tsunami in Japan, 9/11, horse meat masquerading as beef or even the global financial crisis that emerged from 2008 examples that boards may define as beyond our ability to foresee – of course not. Tsunamis have occurred throughout history but that does not mean we should not consider their relevance to any matter regarding a coastal location. Aeroplanes crash, maybe we don’t always suspect a terrorist attack but basis business continuity planning must exist if we build it high or near an airport flight path. Food quality and content is a variable commodity on a global basis and subject to abuse. Financial crisis’s they happen for all sorts of reasons, so how sensitive is our financial plan to fluctuations in relation to our key business assumptions? These are all valid questions that Boards should be asking as they scrutinise and challenge major issues reflecting the strategic direction of the organisation, as they represent the inherent risks to which organisational success is exposed.

The degree of risk appetite that the board is inclined to accept will reflect in a risk reward strategy but it is only through considering what risks the organisations is taking that directors can be content that a course of action is in the best interests of the organisation and principally its stakeholders. Effective risk management allows the board to determine where its risk appetite lies, to consider what are the ‘never events’ that lie beyond this in the ‘red zone’ and therefore where is there potential for catastrophic business failure.

Such an approach does however demand appropriate diligence in selecting non-executive board members; clearly relevant experience is necessary and not just finance as the increasing need to bring essential risk intelligence to the board table has never been greater. The world is an increasingly global community in which technology appears to advance ever quicker, demographics vary, climate change is occurring and instable political sources change the direction of lives, communities and trade. Boards must recognise the environment in which they operate, understand and react to the key threats and dig deep until they are satisfied that sufficient assurance exists.

Directors must recognise the significant responsibilities which they hold reflecting:

- Developing strategy
- Establishing and monitoring policy
- Ensuring compliance with governing documents
- Ensuring accountability
- Compliance with law
- Maintaining effective board performance
- Promoting the organisation
- Proper fiscal oversight

All of which contain a spectrum of risk elements with which they must be familiar and assume responsibility for seeking appropriate assurance in order to promote business success.

Turning to Internal Audit, it has a fundamental role within the assurance agenda and particularly in supporting the role of the Audit Committee, regarding two key components that are critical to organisational success. Firstly, it has a responsibility to provide an opinion regarding the risk management framework. The newly published international Professional Practices Framework 2015 defines it mission as to:

"to enhance and protect organizational value by providing risk-based and objective assurance, advice, and insight”.
As a result, internal audit cannot detract itself from considering what are the major issues and offering a prompt to management regarding ‘have we considered this’?

It also has a responsibility under IPPF standard 2050 to:
"share information and coordinate activities with other internal and external providers of assurance and consulting services to ensure proper coverage and minimize duplication of efforts”.

Taken alongside the reporting standard 2060 which states that the:
"chief audit executive must report periodically to senior management and the board on the internal audit activity's purpose, authority, responsibility, and performance relative to its plan. Reporting must also include significant risk exposures and control issues, including fraud risks, governance issues, and other matters needed or requested by senior management and the board”.

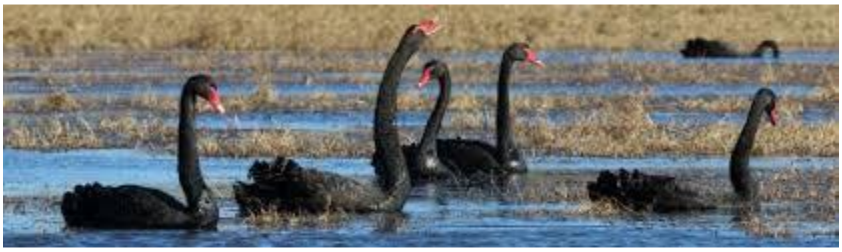
One must conclude that internal audit must engage with the assurance agenda and has a responsibility to engage with the board regarding the significant risks to which the organisation is or may become exposed. For this to be achieved internal audit must surely need to both consider inherent risk and ensure that the board actively engages with the appropriate discussions regarding what could go wrong.

In essence, the answer must lie within implementing the effective and well-established principles of three lines of defence. Such a process not only provides Board with a transparent view of the control framework within the organisation but also acts as a direct link to internal audit planning at a strategic and operational level.

In simple terms, Boards must get to grips with both the framework of control at a strategic level and an understanding of where the appropriate assurance comes from in order to sign off on their responsibilities, this can be summarised as:

Framework element	Purpose in governance	Line of defence	Relevance to internal audit
Corporate objectives	Approve direction as a means of monitoring progress		Understanding
Principal inherent risks	Recognition that risk exists		Advice and challenge
Key controls	Basis of risk reduction to residual level within risk appetite	First	Basis for Internal Audit Planning and provision of assignment and annual opinions
Sources of assurance	Completion of governance statement by directors	Second	Link to standards 2050 and 2060 and provision of risk-based reporting
Gaps in Control	Focus for increased attention and review		Provision of advisory services?
Independent assurance	Verification that control framework is as robust as contended	Third	Internal Audit is just one source of assurance if it has credentials.

Using such an approach ensures not only transparency but that all communication is based upon common grounds of understanding and that it focuses on things that really matter to the organisation in terms of its success, and not just in financial terms. As an experienced non-executive director I have realised that only by understanding some of the wider risk issues can the Board fully appreciate the risk environment that is being addressed and in these terms issues that initially are of an operational nature can manifest themselves to situations in which the organisation becomes exposed to a raft of related risks that threaten both financial stability and reputation.



In ornithological terms black swans may be rare but they nonetheless exist; in risk management terms they are not so rare if you choose to search for them!

If you feel that there may be risks which remain unidentified within your business, it may be that a facilitation exercise at Board, Executive or Senior Management level will help identify the potential impact and therefore ensure that the organisation remains in control regarding achievement of its objectives.

Facilitation exercises and assignments to ensure effective risk management is embedded throughout the organisation are just two of the bespoke assignments which we can undertake and help your organisation succeed.

Please contact us for an informal discussion on how we might help.