BDO

Strengthening Risk Management

The Dutch Corporate Governance Code Monitoring Committee states the necessity of risk management for long-term value creation. An adequate system in which opportunities and risks are balanced should lead to short-term results but not at the expense of future value creation.

Compared to the previous Code the Management Board is expected to:

- Define risk appetite and decide which risk responses reduce risks;
- Identify and assess risks related to the strategy and activities of the company. These risks include external risks as well. In the previous Code, the only requirement was a description in the annual report of strategic risks and related risk responses;
- Design, implement and maintain an internal risk and control framework based on a risk assessment. This risk and control framework should be integrated in business processes and known by all relevant staff;
- Explicitly monitor all relevant risks, including strategic, operational, compliance and financial reporting and at least annually assess these risks against risk appetite as well as the effectiveness of related controls;
- Discuss material weaknesses in internal control with Audit Committee and Supervisory Board;
- Report significant risks and uncertainties that could endanger the continuity of the company the next 12 months.

Long-term value creation and risk management

Most of these principles are specifications of previous requirements and best practices. Depending on the maturity of your risk management and internal control framework, these changes will ask for more or less (re-) work. Investing in strengthening risk management should add value to the company instead of just complying with the code.

new
perspectives

Effective risk management creates value to stakeholders by:

- Timely identifying and seizing opportunities;
- Optimising resource allocation;
- Assuring return on investments;
- Optimising total cost of risk and control;
- Managing stakeholder expectations and protecting reputation.

Although the Code provides high level principles, it invites companies to strengthen risk management as a key management tool. We share our views on how you can create long-term value by effectively applying risk management. Four key elements drive long-term value creation:

1 Understand uncertainty
2 Allocate resources based on risk-return ratio
3 Integrate risk management with performance management
4 Quantify risk appetite and risk exposures

For each of these four key value drivers we propose specific methodologies and tools.

1 Scenario planning

Uncertainties differ from risks because the likelihood of occurrence and potential impact cannot be classified or quantified. Scenario planning is a methodology that supports decision makers to better understand the future and anticipate by selecting the most effective strategic options. Scenarios are built based on the main uncertainties the business is facing, taking into account trends, developments and outside-in perspectives of subject matter experts.

By applying scenario planning, management doesn't fixate on one preferred future state, but can navigate with call and put options in multiple future outcomes. An effective tool for dealing with external risk in a dynamic environment.

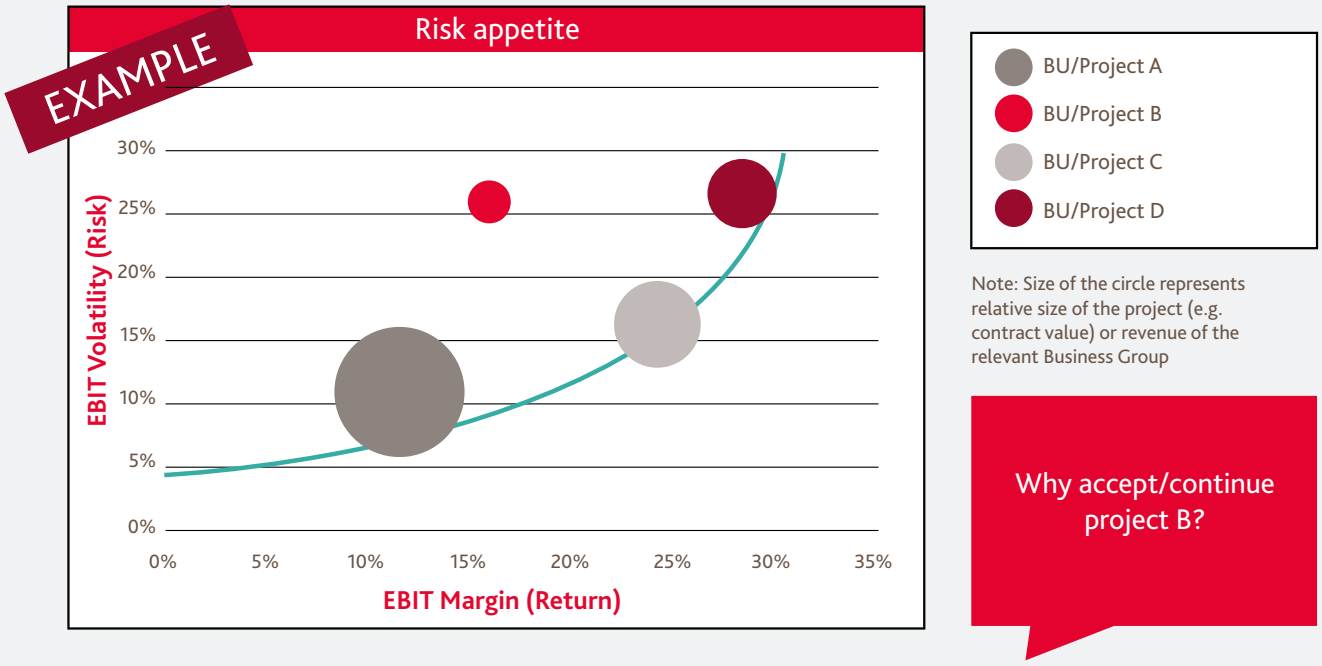
2 Portfolio analysis

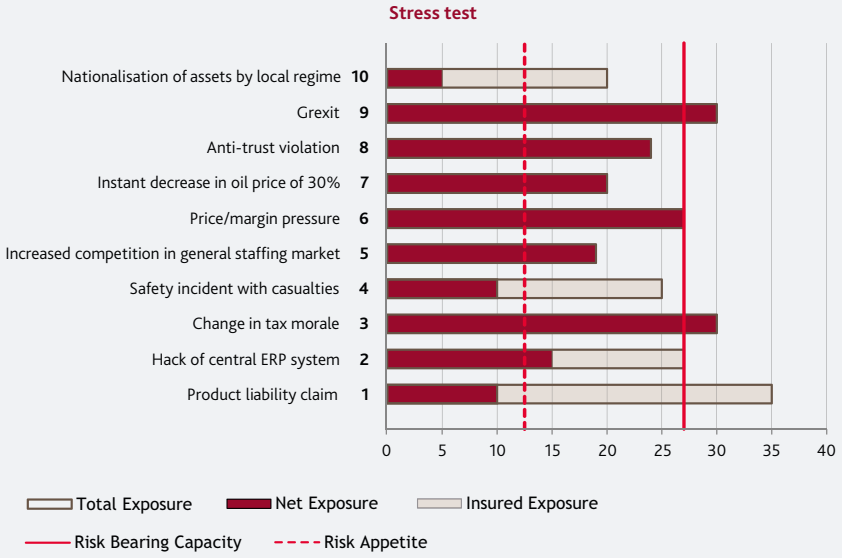
In order to allocate resources in the best possible way, risk and return of decisions should be considered in parallel. One way to evaluate risk-return ratios of businesses, entities, projects or ventures is a portfolio analysis (see below).

In most cases, risk is expressed in terms of volatility of outcomes. More volatility of projected results means higher risk. As long as projected results justify higher risk within the limits of the company's risk appetite, these projects, investments or businesses contribute to long-term value creation. This analysis visualises the spread of risks and returns over the business and is used for strategic resource allocation.

3 Risk based performance management

We fully support the Code's principle of integrating risk management and internal control activities in existing business processes. The best way of doing that is to implement risk based performance management. By adding tolerances to each objective, value driver or performance indicator, risk appetite is operationalised for decision making. By using data analytics to monitor deviations from tolerances, managers have real-time control over their performance and can act instantly.





4 Stress testing

Quantifying risk appetite, delegating risk appetite to accountable managers and quantifying risk exposures establishes a common language understood by management to evaluate risk. Determining risk appetite is typically a top down process, started on group or holding level, cascaded into several activities, businesses, ventures or projects. Risk appetite is the amount of risk that a company is willing to accept to achieve its objectives.

In order to align risk and financial management, we recommend to derive risk appetite from the company's risk bearing capacity. Risk bearing capacity is the amount of risk that a company can absorb without breaching its covenants or financial objectives. By evaluating quantified risk exposures (not taking into account likelihood of occurrence) and risk appetite, management, the management board and supervisors are provided with a clear overview of the internal and external risks that can threaten the continuity of the company and the robustness of (strategic) decisions.

Key considerations

Please consider the following questions about your risk management capabilities and the extent to which they contribute to long term value creation:

- How do you assure that decision making (i.e. resource allocation, investments, new ventures) creates long term value?
- How do you assure that value creation is optimised within the boundaries of risk appetite?
- How do you assure that strategic decisions will not be overruled by external developments or influences?
- How do you assure the total cost of risk and control have been optimised?
- How do you empower and motivate staff at all levels to adopt risks in day-to-day decision making and therewith show risk-aware behaviour?

Closing remark

Complying with the Dutch Corporate Governance Code is one objective, taking decisions that create long-term value the most important one. In our view, Risk Management, Internal Control, Internal Audit and culture should contribute to long-term value creation.

More information

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