Ineffective Risk Management and the collapse of Carillion[1]

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Risk management failings

As reported in the press, on 15 January 2018 Carillion plc, the British multi-national company declared insolvency and the Official Receiver started to liquidate its assets and contracts. The examination of company insolvencies provides valuable insights into failed corporate processes. These lessons are important not only for executives but also for construction managers, project managers, risk managers and advisers. At the heart of the collapse was an acute lack of understanding and management of risk by both the UK government[2] and Carillion itself [3]. The Carillion failure occurred against the backdrop of a growing interest in describing and defining measures of risk capacity and risk appetite. As described by Richard Barfield of PWC[4] "defined well, risk appetite translates risk metrics and methods into business decisions, reporting and day-to-day business discussions. It sets the boundaries which form a dynamic link between strategy, target setting and risk management". When considered together, the Carillion behaviours described below portray a clear absence of operating boundaries based on a risk appetite statement and associated risk metrics. Despite the early warning signs that the company was running into significant difficulties, the company either had a poor perception of the risk it was facing or consciously ignored it. It would appear that it was not until the preparation of Carillion's January 2018 transformation Group Business Plan that there was recognition that the group had "weak operational risk management" [5].

Background

The company predominantly operated in low-margin industries[6] within highly competitive markets with inherent risks[7]. A large element of Carillion's contracts were government construction and facilities management contracts. The collapse was the most spectacular corporate failure in recent memory. The company was described by the House of Commons as "an unsustainable corporate time bomb, characterised by the increasingly reckless pursuit of growth with scant regard for long-term sustainability or the impact on employees,

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[2] The Public Administration and Constitutional Affairs Committee report, "After Carillion: Public Sector Outsourcing and Contracting". https://publications.parliament.uk/pa/cm201719/cmselect/cmpubadm/748/748.pdf /09 July 2018

[3] Commons Select Committees web page www.parliament.uk , Carillion plc. https://publications.parliament.uk/pa/cm201719/cmselect/cmworpen/769/76905.htm .

[4] Richard Barfield/PWC Risk appetite – How hungry are you? https://www.pwc.com/gx/en/banking-capital-markets/pdf/risk_appetite.pdf

[5] Carillion plc , Group Business Plan, January 2018, p 6

[6] Unravelling a web of failures at UK outsourcer Carillion, Financial Times, https://www.ft.com/content/37f63372-58f3-11e8-b8b2-d6ceb45fa9d0, May 16 2018.

[7] UK Parliament (2018) House of Commons Hansard. *Carillion.* 12 July 2018. Volume 644. https://hansard.parliament.uk/commons/2018-07-12/debates/2D8B6F0E-B8C0-47C6-B9D0-D274EC5D72DD/Carillion

pensioners and suppliers"[8]. The collapse attracted intense media coverage and triggered several Parliamentary investigations and inquiries. Once the background to the collapse became apparent a Parliamentary report commented "The mystery is not that it collapsed, but that it lasted so long"[9]. The accumulation of debt and an inability to reduce it caused concerns among Carillion's investors, who had begun to divest themselves of shares towards the end of 2015. For investors generally, perhaps the most striking observation of all was that "Carillion could happen again, and soon" [10]. At the time of its collapse, Carillion was the UK's second largest construction company and second largest supplier of maintenance services to Network Rail. The insolvency left in its wake (i) a pension deficit of approximately £2.6 billion[11] (ii) 30,000 unpaid suppliers with the risk of getting little or nothing back[12] - on 30 June 2017 Carillion owed £2 billion to its suppliers, sub-contractors and other short-term creditors[13], and (iii) uncertainty with regard to approximately 420 contracts with the public sector[14] although other estimates placed the number at closer to 450. Carillion held contracts with the Ministry of Defence, the Ministry of Justice, Network Rail, HS2 Ltd and various hospitals. At the time of liquidation Carillion employed around 45,000 people of which 18,200 were located in the UK.

Carillion behaviours

The House of Commons report[15] was damming in its summary of the behaviour of Carillion's board of directors. These behaviours all contained an element of risk that had a compounding effect.

> *Carillion's rise and spectacular fall was a story of recklessness, hubris and greed. Its business model was a relentless dash for cash, driven by acquisitions, rising debt, expansion into new markets and exploitation of suppliers. It presented accounts that misrepresented the reality of the business, and increased its dividend every year, come what may.*

The use of the word 'recklessness' brings to the fore memories of Northern Rock. The House of Commons Treasury Committee inquiry held to identify the lessons to be learned from the failure

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[8] House of Commons web page. www.parliament.uk , Carillion plc. https://publications.parliament.uk/pa/cm201719/cmselect/cmworpen/769/76908.htm

[9] House of Commons, Business, Energy and Industrial Strategy and Work and Pensions Committees. **Carillion.** *Second Joint report from the Business, Energy and Industrial Strategy and Work and Pensions Committees of Session 2017–19.* 16 May 2018, https://publications.parliament.uk/pa/cm201719/cmselect/cmworpen/769/769.pdf

[10] Ibid

[11] UK Government. Commons Select Committee. *Pension scheme trustees questioned on Carillion*. 30 January 2018. https://www.parliament.uk/business/committees/committees-a-z/commons-select/work-and-pensions-committee/news-parliament-2017/carillion-pension-trustees-17-19/

[12] BBC (2018) *Carillion collapse: Insurers pay out £30m to suppliers*, 25 January.

[13] 'Trade and other payables', p. 21 of the Carillion *Interim financial statement for the six months ended 30 June 2017*

[14] Report by the Comptroller and Auditor General, Investigation into the government's handling of the collapse of Carillion, Session 2017–2019, HC 1002, p6.

[15] House of Commons, Business, Energy and Industrial Strategy and Work and Pensions Committees. Carillion**.** *Second Joint report from the Business, Energy and Industrial Strategy and Work and Pensions Committees of Session 2017–19.* 16 May 2018. https://publications.parliament.uk/pa/cm201719/cmselect/cmworpen/769/769.pdf

of UK banks during the 2007-2008 financial crisis[16] identified that among the banks that ran into trouble, there was evidence of a direct correlation between risk exposure and leverage. As banks increased their borrowings, the risk of their inability to repay their borrowings due to a fall in income increased[17]. In its findings the inquiry acknowledged that those financial firms that showed the greatest appetite for rapid growth through leverage were amongst the heaviest casualties. Increased debt simply led to increased risk. An example was the British bank Northern Rock. It was the first British bank in 150 years to fail due to a bank run[18]. As stated in the inquiry report "the directors pursued a reckless business model which was excessively reliant on wholesale funding". There are clear parallels between Northern Rock and Carillion particularly with regard to the extent of their borrowings.

Acquisitions: Much of Carillion's growth was achieved through acquisition. When undertaking acquisitions Carillion paid questionable amounts for "goodwill", the accounting term used to describe the difference between the net assets and the amount paid. Goodwill represents the intangible assets (such as company brand, skills and experience of the workforce, patents, trademarks and copyrights), as opposed to physical assets like buildings and equipment. The appropriate value of goodwill is very hard to define. It is possible for an acquiring company to pay too much for goodwill. While purchasing rivals such as Mowlem and Alfred McAlpine, Carillion addressed market risk by removing competitors for major contracts, however they purchased these companies and others for substantially more than their tangible net assets. There was a clear perception that Carillion overpaid for these acquisitions. As identified by the House of Commons Hansard team Carillion manipulated the unrecoverable goodwill to prop up its balance sheet and allowed the notional values of goodwill to sit on the balance sheet year after year, without any re-assessment with the result that "when the company collapsed, the goodwill was wiped out, showing its true value—a value of zero"[19].

Aggressive accounting: Carillion adopted what has been termed 'aggressive accounting', a practice of declaring revenue and profits based on optimistic forecasts, before the profits have actually been realised. For business longevity, this approach is dependent on forecasts being accurate. However if costs rise and revenues fall (as a result of say unexpected construction costs and or completion delays on fixed price contracts), expected profits turn into actual losses. Emma Mercer, the former Carillion chief financial officer stated (during her testimony before members of Parliament attending the House of Commons enquiry on 6 February 2018) that when Carillion's management saw contracts deteriorating in 2017, the aggressive accounting adopted made it very difficult to "withstand those deteriorations"[20].

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[16] House of Commons. Banking Crisis: dealing with the failure of UK banks. House of Commons Treasury Committee, Seventh Report of Session 2008-2009, 1 May 2009.

[17] Chapman (2011). Simple tools and techniques for enterprise risk management. John Wiley and Sons Limited.

[18] The Guardian (2012). Financial crisis: timeline. The financial crisis, five years on: how the world economy plunged into recession. Patrick Kingsley, Tue 7 Aug 2012. https://www.theguardian.com/business/2012/aug/07/credit-crunch-boom-bust-timeline

[19] UK Parliament (2018) House of Commons Hansard. *Carillion.* 12 July 2018. Volume 644

[20] Engineering News Record. When Carillion's Leaders Missed The Biggest Risk Of All. February 28, 2018. Richard Korman and Peter Reina. https://www.enr.com/articles/44058-when-carillions-leaders-missed-the-biggest-risk-of-all

Dividend payments: Dividends are a distribution of profits. Typically there is pressure on companies to, at the very least, maintain dividend payments. Dividend payments can be seen as a barometer for indicating changes in financial position, positive or negative. It is possible to get an idea of the financial health, management attitude and expansion plans simply from a company's dividend policy. Hence downward adjustments to dividend payments can significantly affect shareholders trust, the company's share price and its overall reputation. While declared profits can be based on expectations, dividends are paid out in liquid assets- money. When dividends are paid on the basis of expected profits, the company is effectively borrowing money to pay its shareholders[21]. In the five years from 2012 to 2016, Carillion paid out £63 million more in dividends than it generated in cash from its operations[22].

Borrowing: Carillion rejected opportunities to inject equity into the growing company and instead funded its spending spree through debt. Over the eight years from December 2009 to January 2018, Carillion extended its borrowing from £242 million to an estimated £1.3 billion – more than five times the value at the beginning of the decade[23].

Cost information: Carillion's senior management lacked adequate financial information to manage the business. A review conducted in January 2018 by FTI Consulting for Carillion's lenders found the "presentation and availability of robust historical financial information", such as cash flows and profitability, to be "extremely weak"[24].

Risk management: The statements regarding risk management in Carillion plc's 2016 Annual Report and Accounts (published in March 2017) appear incongruous when compared with the Board's actual behaviour exposed by the collapse.

- The Chairman declared within his statement "the Board maintained its focus on […] assessing the Group's risk management and control processes and on constructively challenging the Executive Directors"[25].
- Under the heading "High standards of corporate governance" the report states: "This is a cornerstone of our business, with rigorous policies, procedures and mandatory training that are designed to create a responsible business culture, which defines the way we do business and enables us to achieve high-standards of customer service, risk management and accountability".
- Under the section headed "Our business model", "Rigorous risk management is critical to the attainment of our strategic objectives and it continues to remain a key part of our business model".
- Under the section headed 'Our risk management process' The Directors confirm that they have carried out a robust assessment of the principal risks facing the Group,

[21] House of Commons Library. Carillion collapse: what went wrong? January 19, 2018. Federico Mor. https://commonslibrary.parliament.uk/economy-business/business/carillion-collapse-what-went-wrong/
[22] Ibid
[23] Ibid
[24] Carillion plc, FTI Consulting, Independent Business Review, January 2018
[25] Carillion plc's 2016 Annual Report and Accounts (published in March 2017)

including those that would threaten its business model, future performance, solvency or liquidity.

Carillion plc's 2016 Annual Report and Accounts provide a window into the company's assessment of risk. There are a number of anomalies in the Report. The following bullet points are based and an expansion of the Institute of Risk Management's 2017 Consultation Paper "Proposed Revisions to the UK Corporate Governance Code" and provide a summary of the shortcomings in risk management:

- While a list of principal risks is provided (pages 32 to 37), these risks are not aligned with the subject areas described in the "Viability Statement" provided.
- The list of principal risks do not relate to the subjects of business model, performance, solvency or liquidity as discussed under the Report heading "Our risk management process".
- The Report does not clearly explain how risk management supports decision making. There is a lack of evidence that risk information is used to support strategy, tactics, operations and compliance activities.
- The risk management information provided is insufficient to indicate the true health of the company.
- There appears to be a disconnect between the risk identification undertaken and identification of the risks that would impact the success and viability of the company, such as an inability to raise finance.
- The risk matrix is simplistic and unhelpful. It is unclear how this would help executives, shareholders and stakeholders alike.

The Annual Report list the following as the top ten principal risk subjects. It states "The occurrence of the above risks could have a significant impact on the Group's financial position and the simultaneous occurrence of multiple risks could compound the overall financial impact". However in the event that these risks materialised, they would have starkly different financial impacts.

1. Work-winning
2. Contract management
3. Pension liabilities
4. Brexit
5. People
6. New markets and services
7. Ethics and compliance
8. Systems and cyber security
9. Health and safety
10. Human Rights

Within Carillion's 2016 annual accounts there is no reference to a Risk Appetite Framework (see Appendix 1), Risk Treatment Options (see Appendix 2), Risk Appetite Scales (see Appendix 3) or Risk Appetite Statement (see Appendix 4), all critical for effective decision making. These subjects are discussed briefly in the appendices to aid comprehension of their typical content.

Internal Auditors: Carillion's board were supported by Deloitte who acted as Carillion's internal auditors. The role of internal audit is to provide independent assurance that an organisation's risk management, governance and internal control processes are operating effectively. Although Deloitte made a number of recommendations through their internal audit reports, government reports indicate the identification of high priority issues was rare. The reports went on to say they did not appear to have expressed concern over the high risk to the business of the very high cost overrun of a small number of contracts. Specifically Deloitte were responsible for advising Carillion's board on risk management and financial controls. Failings in both proved fatal for the business[26]. The House of Commons commented: "Deloitte were either unable to identify effectively to the board the risks associated with their business practices, unwilling to do so, or too readily ignored them" [27]. To fathom their behaviour the same report considered: "Advisory firms are not incentivised to act as a check on recklessly run businesses. A long and lucrative relationship is not secured by unduly rocking the boat"[28].

Non-Executive Directors: Carillion was governed by a seven-member board, comprising the company's Chief Executive, Finance Director and five non-executive directors[29]. The company's non-executive directors, it is claimed, failed to scrutinise or challenge reckless executives. A House of Commons report stated: "Non-executives are there to scrutinise executive management. They have a particularly vital role in challenging risk management and strategy and should act as a bulwark against reckless executives. Carillion's NEDs were, however, unable to provide any remotely convincing evidence of their effective impact"[30].

Contract management: Carillion's audit committee papers showed that at least 18 different contracts had provisions made against them. Three of the main projects in trouble in the UK were the Royal Liverpool hospital PFI project, the Aberdeen Western Peripheral Route and Balmedie-Tipperty road and the Midland Metropolitan hospital PF2 project.

UK government behaviours

Government monopoly: A significant factor in the demise of Carillion was that the Government's position in some public sector markets was (and remains) monopolistic. As a consequence the government has very considerable power as the only buyer in these markets to stipulate the risk to be absorbed by bidders, to set prices and standards of quality.

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[26] Web page www.parliament.uk. House of Commons, Carillion plc.
https://publications.parliament.uk/pa/cm201719/cmselect/cmworpen/769/76905.htm
[27] Ibid
[28] Ibid
[29] Carillion plc, 2016 Annual Report and Accounts, pp 50–51
[30] Web page www.parliament.uk. House of Commons. Carillion. Conclusions and Recommendations.
https://publications.parliament.uk/pa/cm201719/cmselect/cmworpen/769/76908.htm

Government transfer of risk: The Government it is claimed deliberately promoted an aggressive approach to risk transfer to the private sector - often even attempting to transfer risks that the government itself has completely failed to analyse or to understand[31]. The Chair of PACAC, Sir Bernard Jenkin MP, said: "It is staggering that the Government has attempted to push risks that it does not understand onto contractors, and has so misunderstood its costs[32].

Payment by results: The Public Administration and Constitutional Affairs Committee stated the adoption of 'payment by results' has proved to be counter-productive, as follows:

> UK governments have often transferred risks to contractors that they cannot possibly manage. This is driven, in part, by the decision to use contractual models such as payment by results which involve risk transfer on a huge scale. The transfer of large amounts of risk is often counter-productive: leading to more conservative approaches to service delivery. This situation has been made worse by the fact that governments have often not understood fully the services or projects they have wanted the private sector to manage and without any understanding or data about the assets being handed over[33.]

Consensus on approach adopted by government: During House of Commons inquiries it transpired that there was a clear consensus among a number of commentators that successive governments have sought to transfer risk inappropriately and that they continue to do so.

- Rupert Soames, Chief Executive of Serco (which also provides outsourced services) said that in his view "Government has started transferring unmanageable amounts of risk into the private sector". He recommended public agencies should refrain stipulating a requirement such as the requirement that contractors bear risk for regulatory and legal changes for 10 years.[34]
- Michael King, the Local Government Ombudsman remarked that "all too often" local authorities try to outsource responsibility for a contract as well as operational risk.
- Professor Sturgess wrote in 2017 that "the experience of recent years has been that [government] procurement teams are aggressively seeking to maximise risk transfer"[35].
- The NAO found that the Home Office had allocated risks to Raytheon, the IT contractor on the Eborders programme, which the company had "proved ill-placed to manage"[36].

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[31] House of Commons. The Public Administration and Constitutional Affairs Committee publishes its latest report, "After Carillion: Public Sector Outsourcing and Contracting". 09 July 2018. https://publications.parliament.uk/pa/cm201719/cmselect/cmpubadm/748/748.pdf

[32] Web page www.parliament.uk. Commons Select Committee. Carillion collapse exposes fundamental flaws in Government outsourcing. 09 July 2018.

[33] "After Carillion: Public sector outsourcing and contracting. https://publications.parliament.uk/pa/cm201719/cmselect/cmpubadm/748/74807.htm

[34] Engineering News Record. When Carillion's Leaders Missed The Biggest Risk Of All. February 28, 2018. Richard Korman and Peter Reina. https://www.enr.com/articles/44058-when-carillions-leaders-missed-the-biggest-risk-of-all

[35] G. Sturgess, Just another paperclip: Rethinking the Market for Complex Public Services, Business Services Association, March 2017, pp. 10–11

[36] Comptroller and Auditor General Eborders and successor programmes (December 2015) p. 10, 34

- The think tank the Institute for Government reported that the Government is "transferring more financial risk onto providers"[37].
- A recent report by the CBI recorded that 37% of businesses who work with the Government felt that the "government's handling of risk had deteriorated since 2015, with almost half stating there had been no improvement during this period"[38].
- The NAO stated that when designing payment by results schemes, the Government needs "to understand potential providers' capacity to take on risk"[39].It is not clear that the Government have done this.
- Paul Davies, a partner of PWC's Infrastructure and Government team in the UK and Capital Projects and Infrastructure global network, commented the Government's approach of pursuing the lowest possible cost and the highest possible risk transfer has flowed from a very transactional approach to contracting

Summary

The UK parliamentary investigations and inquiries referred to above highlight a number of failings in management practices and risk management specifically, as summarised in Figure 1 below. While there were discernible shortcomings in the approach adopted by Carillion, internal and external stakeholders exacerbated the delivery of contracts in what have been described as highly competitive markets where margins are notoriously low. The government itself, internal auditors and the non-executive directors were singled out as parties which either introduced risk or were ineffective in supporting its management. This short article has not attempted to record every aspect of Carillion's debilitating company behaviour or the shortcomings in risk management but provide an overview. While the role of risk management is to provide information to support effective decision making, the prerogative of executives is to choose the most appropriate information to base their judgements upon. It is not always clear what information they receive and what they ignore. It is hoped they will make unbiased decisions, preserve diversity of thought and independent thinking, clarify assumptions and make decisions which will preserve the longevity of the company. However to the dismay and disappointment of the government, investors, suppliers and employees, Carillion's directors chose short-term gains over the long-term sustainability of the company, with dramatic results.

[37] D. Crowe, T. Gash and H. Kippin, Beyond Big Contracts, Institute for Government and Collaborate, January 2014, p. 6
[38] CBI, Partnering for Prosperity: CBI/Browne Jacobson 2018 Public Procurement Survey, June 2018, p. 12
[39] National Audit Office The Work Programme (June 2014) p. 7

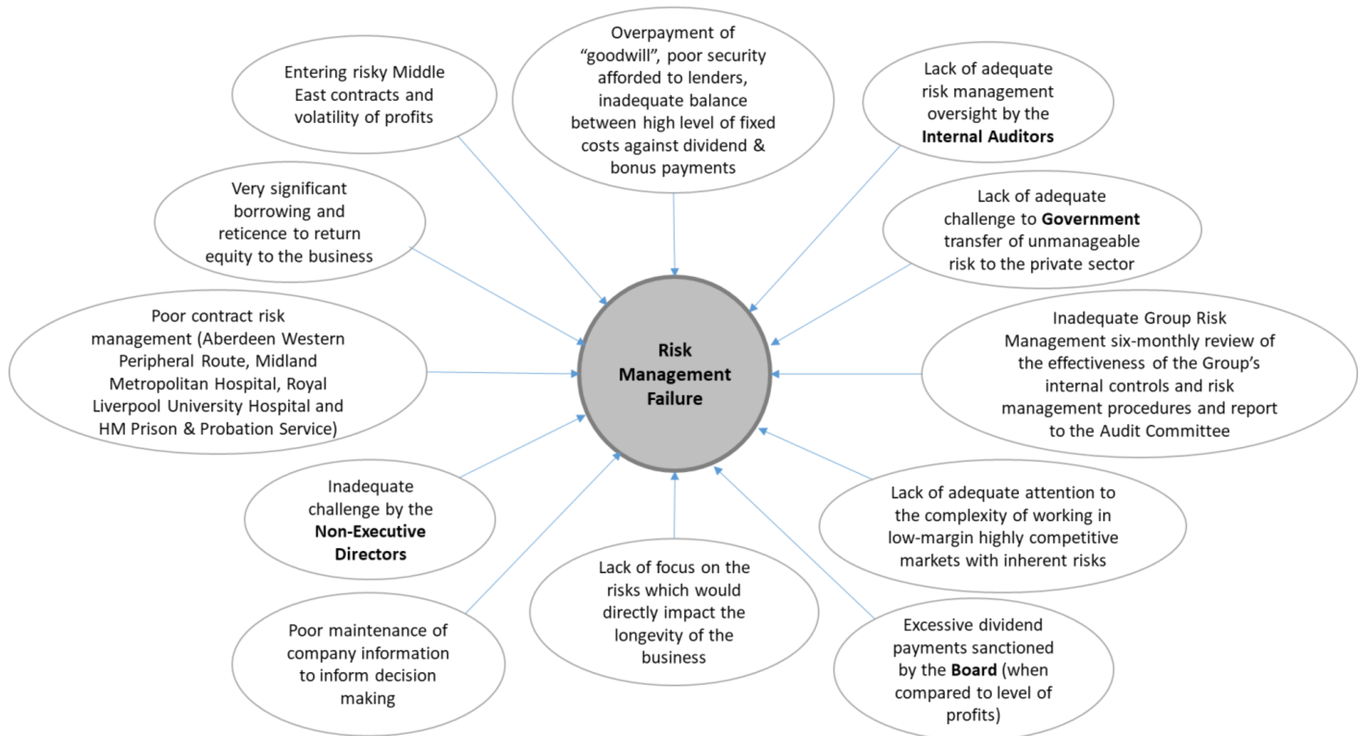

Figure 1: A number of the primary factors leading to a failure of risk management at Carillion

APPENDIX 1

Risk Appetite Framework

The following eight steps support the development of a Risk Appetite Framework for individual companies which can be aligned to their unique mission and to the amount of risk they are willing to accept to achieve their strategic goals and objectives.

- **Understand the company's strategic goals and objectives**. A company's risk appetite is directly related to its strategic goals and objectives. By highlighting what the company wants to accomplish, a CRO can articulate how much risk the organization is willing to accept in pursuit of those goals.

- **Establish risk treatment categories**. Establish risk treatment categories and their description.

- **Develop a Risk Appetite Scale**. After identifying the goals and objectives the company wishes to achieve, the next step is to articulate the amount of risk the organization is willing to take to achieve those objectives. One way of identifying and communicating the level of risk a company is willing to take is to create a Risk Appetite Scale, which provides a system of gaining uniform consensus across an enterprise on the level of risk the organization is willing to take. The scale can be used to assess the level of risk the company wishes to accept for a particular risk exposure area.

- **Agree the terms and their definitions to be universally adopted**. The terms and their definition that will be in everyday use must be set down and agreed so that there is a common language. This is particularly important for large companies. Otherwise risk descriptions, causes, impacts and responses may lead to confusion and undermine risk management processes.

- **Determine the primary areas of risk exposure**. While the use of a risk taxonomy will provide a broad definition of risk exposure, the company must establish those risks that would impact the longevity of the company such as (but not limited to) finance, expertise, market share, contracts and compliance. These primary risk areas will inform the preparation of the Risk Appetite Statement.

- **Engage the Board**. Once the goals and objectives together with the Risk Appetite Scale, Terminology, Taxonomy and primary areas of risk have been established senior management need to be engaged to determine how much risk the organisation is willing to take as it relates to its business activities. By collecting, aggregating and synthesizing the feedback gained, the company's risk appetite can be defined. Subsequently every discussion around the options to pursue and every decision the Board and senior

management make, should reflect the organization's level of risk aversion or risk acceptance.

- **Prepare a Risk Appetite Statement**: A major component of the Risk Appetite Framework involves the development of a Risk Appetite Statement. By describing the company's risk appetite in a clear and concise manner, all stakeholders, both internal and external, should be able to make risk intelligent decisions which fall within the enterprise's risk appetite. This requires that the Risk Appetite Statement should be based on the agreed Taxonomy and Terminology.

- **Tailor reporting to the Board's needs**: Information is the life blood of any organisation. For Board members to be able to make informed effective decisions risk information must be escalated to the Board in a clear, concise and timely manner clearly articulating the decisions required. The risk information should reflect the previously agreed Risk Appetite Statement.

The Risk Appetite Framework and its components should be revisited and updated as required on a regular cycle.

APPENDIX 2

Risk Treatment Options

A company must agree on the risk treatment terms to be adopted and their definitions to support the development of Risk Appetite Scales and a Risk Appetite Statement as well as ongoing risk management. One reason being that if there are multiple terms in use within a company, communication of proposed responses can become confused. One suggested set of terms is recorded below drawn from Chapman, 2011[40].

- **Remove:** (Also known as avoidance, elimination, exclusion and termination). Risk removal is the strategy adopted to eliminate a risk altogether when a negative outcome is anticipated.

- **Reduce:** (Also known as treatment or mitigation). Risk reduction is the strategy adopted to diminish a risk occurrence in terms of its probability and or its impact.

- **Retain:** (Also known as acceptance, absorption or tolerance). Risk retention is the strategy adopted when either it is more economic to do so or there is no alternative but to retain.

- **Re-assign:** (Also known as transfer and deflection). Risk retention is the strategy adopted to move a risk onto another entity, business or organisation. Re-assignment typically occurs through taking out insurance policies, however many policies have the equivalent of 'excess' clause like motor insurance whereby the party taking out the insurance has to pay an element of the loss.

[40] Chapman (2011). Simple tools and techniques for enterprise risk management, 2nd Edition. John Wiley and Sons Limited.

APPENDIX 3

Risk Appetite Scales

The development of Risk Appetite Scales are required to support the preparation of a Risk Appetite Statement.

	Risk Seeking	Risk Tolerant	Risk Neutral	Moderately Risk Averse	Risk Averse
Risk taking vs. reward	Company believes aggressive risk taking is justified when assessed against the potential rewards	Company is willing to take greater than normal risks	Company takes a balanced approach to risk taking	Company takes a cautious approach towards risk taking	Company adopts a very cautious approach and often accepts as little risk as possible
Objective / negative impact relationship	Willing to accept a large negative impact in order to pursue strategic sub-objectives	Willing to accept a degree of negative impact in order to pursue strategic sub-objectives	Potential successful and negative impact in pursuing strategic sub-objectives given equal consideration	Only willing to accept a small negative impact in order to pursue strategic sub-objectives	Not willing to accept any negative impact in order to pursue strategic sub-objectives
Preferred risk response approach	Risk is **retained** as sanctioned by senior management / the Board	Preference to **retain** or **reduce** risk through risk management processes.	No preference to the risk response approach to be adopted.	Preference to **remove** the risk or **re-assign** it to an outside party or adopt an alternative strategy	Those risks that cannot be effectively **reduced** or **re-assigned** are **removed**.
Risk response decision criteria	Minimum if any risk response actions are taken	Risk response actions are taken when a strong case can be made for cost effectiveness of potential outcomes.	Risk response actions are made based on cost effectiveness, management priorities and potential outcomes	Incidence costs are given a relatively higher priority when risk response actions are considered	Risk response actions are taken even though prevention costs are greater than expected incidence cost

Figure 2: Based on “Federal CFO Insights: How Hungry Are You? Building a Federal Risk Appetite Framework” Deloitte & Touche LLP, 2014.

APPENDIX 4

Risk Appetite Statement

Stages of development

The stages typically involved in developing risk appetite statements as described by the IRM document "Risk Appetite Statements"[41] are as follows:

1. Identify stakeholders and their expectations, together with an analysis of the risks to strategy, tactics, operations and compliance, as set out in the risk register.
2. Establish the desired level of risk exposure that will lead to a risk appetite statement that provides a set of qualitative and quantitative statements.
3. Define the range of acceptable volatility or uncertainty around each of the types of risks leading to a statement of acceptable risk tolerances.
4. Reconcile the risk appetite, risk tolerances with the current level of risk exposure and plan actions to bring current risk exposures into line with risk appetite.
5. Formalize and ratify a risk appetite statement(s), communicate the statement with stakeholders and implement accordingly.

Typical contents of a Risk Appetite Statement

Introduction: General description of the company, the context of the company (i.e. if it is operating within a regulated industry), the high level corporate governance requirements and the company's primary objectives. In addition inclusion of a statement similar to the following: "This Statement considers the most significant risks to which the company is exposed and provides an outline of the approach to their management. All strategic and business plans for functional areas need to be consistent with this Statement". The Risk Appetite Statement is to be read in conjunction with the Risk Appetite Framework and the Risk Appetite Scales.

General statement of appetite: This section may describe in broad terms the organisation's environment, operating context and goals and the categories of risk it may face as a consequence. It may also describe the risk appetite for each of the categories and explain the approach that will be adopted in relation to how the risks will be managed in terms of people, process and systems.

The Risk Management Framework: This section may provide a high level overview of the contents of the framework, such as:

- Leadership and governance are established including the creation of a mandate for effective risk management throughout the organisation.
- Accountability and responsibility for risk management activities are made explicit.
- The establishment of compliance requirements and how they are to be adhered to.

[41] IRM (2017) Risk Appetite Statements, https://www.theirm.org/media/3296897/0926-IRM-Risk-Appetite-12-10-17-v2.pdf

- The risk management culture ensures risk management is integral to all aspects of the organisation's activity.
- These risks are identified, assessed and managed at both an enterprise level ('top-down') and operational level ('bottom-up').
- A central risk function has been established composed of experienced risk management specialists to address the requirements of people, process and data capture.
- The Risk Management Committee has oversight over the risk management processes.
- Continuous improvement is managed through the adoption of a risk maturity model.

Risk Exposure: This section will describe the key risks facing the business and the organisation's risk attitude to each based on the Risk Appetite Scales.

Implementation of the Company's Risk Appetite: This section will describe the 'who', the 'how' and 'when' of implementation focussing on integration with risk management processes, the application of risk metrics and the escalation of risk to the executive.

Review: This section will describe the review of the appetite for the risk categories, the individual significant risks and the risk appetite statement as a whole.

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