CHAPTER 8 - Strategic evaluation and choice

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8.7 Risk Management

Active reading: Note that not all risk is bad, but that effectively managed some risk can be beneficial. Also, note that the accounting role is to aid in the quantification of risk in financial terms.

There is now an increased awareness of the need to consider strategic risk and the management of risk when making strategic decisions. Therefore, due to the increasing accountability and responsibility attached to good stewardship of organizations, in which accountants play a key role, this section briefly reviews the management of risk.

Toward a Definition of Risk

Risk is often seen as unfavorable; however, in business (and in investment), there is a risk-reward relationship, that is, the higher the risk, the greater the reward. Therefore, not all risk is necessarily a bad thing. Luhmann (1996: 3) defines risk as "the threat or probability that an action or event will adversely or beneficially affect an organization's ability to achieve its objectives." This definition suggests that risk can be beneficial as well as adverse. The purpose of risk management is not to eliminate risk, as this might be too costly, but to manage the risk to an acceptable level—acceptable to whom? —the stakeholders, and almost certainly the key players.

Types of Risk

There are many different classifications or types of risks that organizations face. It is not the intention to provide a comprehensive list, but typical headings might include:

- Business or operational risk relating to the activities carried out within an organization
- Financial risk relating to the financial operation of a business
- Environmental risk relating to changes in the political, economic, social, and financial environment
- International risk relating to economic and political factors
- Reputation risk caused by failing to address some other risk

Accountants are likely to experience risk in various situations in the working environment, for example, the financial risk concerning the financing methods and foreign exchange risk. Audit risk in terms of inherent risk that is inherent in some areas, for example, dealing with high volumes of cash, and control and detention risk, that is the whether the control audit tests are likely to find any errors. There are other areas, however, that are not strictly financial where accountants have an input, such as new product development with life cycle and target costing, investment appraisal, product liability, and personal liability. Risk in all its forms will have some financial consequences for the organization, and therefore it needs effective management.

The Risk Management Process

There are some key steps in managing the risk, most of which are self-explanatory. For example, the risk management process at Lego® sets out to manage the risk by identifying the risk early, ahead of the strategic decision, that is, they are taking the decision knowing what the risks are and how they could be mitigated. They then measure the risk on a risk impact scale. Based on previous experience, they can assess the level of risk that a strategic decision poses to the organization and other stakeholders. This example highlights the importance of monitoring decisions and their outcomes so that it contributes to organizational learning and can inform future decision making. Lego® also assesses the financial impact of the risk. A strategy is then developed to manage the risk, which includes delegating responsibility to managers.

The Committee of Sponsoring Organizations (COSO, 2004) published guidelines on enterprise risk, which recognizes that risk occurs at all levels in the organization, for example, strategic, business, and operational, as well as in all functions. It is also worth noting that many corporate governance codes of practice and laws that have been implemented in different countries require organizations to identify the risks associated with the business and how they intend to manage them.

COSO (2004) highlights the following benefits:

- Risk appetite is considered in setting strategy
- Helps the organization to choose the best risk response
- Reduces operational surprises and losses
- Identify and manage risks across different parts of the organization
- By considering potential events, management is better able to seize opportunities
- Better risk information allows management to deploy capital more effectively

A typical risk management process is set out in Figure 8.5.

A key point to note is that risk is the responsibility of the senior management team; however, they can delegate to a risk management group within the organization, often with a risk manager in charge, but it remains the senior management's overall responsibility. The starting point is the business strategy, as this will ensure that the specific risks associated with a particular course of action are identified. When evaluating risks, the risk appetite is an important concept as individuals have different appetites. For example, some individuals are risk-averse, while others are risk-loving, and others are risk-neutral. The senior management team will include a mix of individuals, all with individual risk appetites, but collectively, via their strategic decisions, the management team will exhibit a risk appetite of its own.

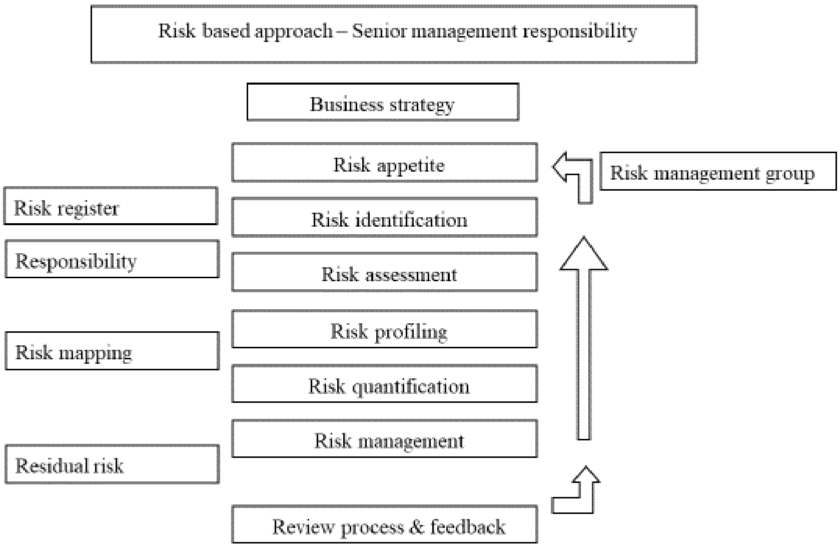

Figure 8.5 The risk management process

The risk appetite of a senior management team is significant as it indicates their willingness to accept and manage risk, which will attract certain types of investors. The risk of strategic options needs to be assessed with knowledge of the kind of investor that the organization attracts. If, for example, a new CEO is appointed who has a different risk profile and convinces the senior management to pursue a more risky strategy to combat the changes in the environment, it may upset some of the more risk-averse shareholders. These shareholders may sell their shares for safer investments, but attract new shareholders who like the more robust risk approach being adopted. This clientele effect of attracting certain types of shareholders can mean that a change in the risk profile of the strategy adopted impacts on the share price, even if only in the short term.

The risk identification stage is self-explanatory in that the risks are identified and, more importantly, are then logged in a risk register with the responsibility being assigned to an individual, which ensures that someone takes responsibility for managing the risk.

The stages of risk assessment, profiling, and quantification merge in that they involve identifying the type of risk, determining the degree of risk, and estimating the potential impact (including the financial impact) of the risk. A business impact analysis identifies and assesses in financial terms and operational terms the effect of disruption on the business. Strategies can then be developed to get the business back up and running as quickly as possible following any disruption. This will involve training people and communicating the recovery plan to make sure that everyone knows what to do if a business disruption event occurs.

Different strategies can be adopted. A simple framework for assessing the degree of risk is shown in Figure 8.6.

Figure 8.6 – Severity versus frequency risk assessment

The matrix enables risks to be assessed in terms of the severity of the impact on the business and the frequency with which events may occur. Strategies shown in Figure 8.7 can then be developed and implemented to mitigate the risk.

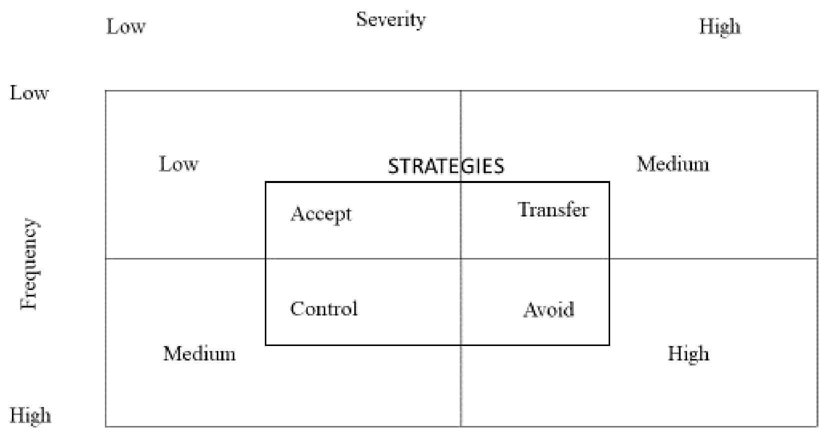

Figure 8.7 – Risk strategies

The labels of accept, transfer, control, and avoid are sometimes given as tolerate, transfer, treat, and tailor. The tailor often suits the high – high category as it there is potentially nothing inherently wrong with a high degree of risk, so long as it is managed correctly.

Some risks are inevitable and may have a low impact on the business but occur infrequently; therefore, the organization may decide to accept the risk and deal with the consequences as they arise. For example, it could be that the incident of product failure is exceptionally infrequent, so a low degree of testing and inspection may be undertaken. In cases where the product is relatively inexpensive, if the product did fail, a policy of merely replacing it free of charge for the customer could be adopted. It may have the added benefit that customers feel good about the organization as the product was replaced without question. This policy links to the cost of quality, as it might be less expensive to simply replace rather than undertake high levels of testing and inspection. The accountants can assist in establishing the trade-off in financial terms.

A typical example of transferring risk is insurance. Also, outsourcing may be an option in situations where a degree of expertise is required. Outsourcing can reduce the risk of the organization undertaking an activity in which it has a lower level of expertise than a specialist organization. In the outsourcing situation, however, the organization does not transfer the full risk as it still has ultimate responsibility for the overall quality of the product or service. Still, it has part of the risk under control as it becomes a contractual risk with the organization to which the activity was outsourced.

Where the risk of failure could occur frequently, the risk can be mitigated by introducing enough controls so that it is managed effectively. It is not, however, just a case of establishing high levels of controls, as to over control an area can be expensive and a waste of time and money, so the risk requires proper assessment. Then an appropriate degree of control can be implemented.

The ultimate objective is to manage risk to an acceptable level as it is not always possible to eliminate the risk altogether. However, the organization must assess whether the residual risk is acceptable to the key stakeholders. The final element is to review the risk and risk management strategy regularly, particularly considering the changing business environment. For example, the growing incidence of cybercrime creates additional risks for organizations that can have reputational impacts.

The control cycle of risk management has three key phases: detection, correction, and prevention. The system in place needs to be able to detect when something has gone wrong. The organization then needs to be able to correct the deficiency. And, crucially, there need to be controls put in place to stop it happening again. It is this phase that, due to pressures of running a business, organizations frequently do not invest enough time and effort in investigating why something went wrong. And subsequently making changes where necessary, or inputting controls so that it does not go wrong again. This follow-up phase is linked very closely with total quality management and lean systems in that continuous improvement is a goal of the organization and identifying failures, correcting them, and preventing them from reoccurring should be part of the culture of the organization.

Learning activity.

The Directors of the E Company Limited are in danger of losing a major contract to a competitor organization, which could result in significant redundancies being necessary to ensure the company's long-term viability. The company produces chemical products that are sold to agricultural sector companies who then mix them in specific quantities to create a range of pesticides and fertilizers that they sell to governments and farmers in less developed countries. The industry is becoming increasingly competitive as the governments can drive down prices by offering volume contracts and, in some instances, incentives to build production plants in the overseas countries, which results in reduced distribution costs.

E Company Limited is under increasing pressure to reduce prices and to cut costs had made changes to the production process by investing heavily in new technology. The introduction of the new process had created a near pollution episode that was recorded by its quality control department. The Production Director was aware of the incident but said nothing to the customer as the event had not created any problems and had been unreported in any external context. None of the other Directors were aware of the incident.

The Company operates a code of conduct that clearly states that the officers must always act with the utmost honesty and integrity. The Company was granted a renewal of the contract as its price was lower than competitors. This lower price was made possible by the reduced costs of production due to the changes made in the production process. However, following the renewal of the contract, an internal audit report identified the pollution incident as a potential risk. The Directors were surprised to see the incident mentioned and were meeting to discuss the action to be taken.

Question 1

Which ONE of the options (A – E) includes the actions listed (i – v) that would be the MOST appropriate in the circumstances?

(i) Request the resignation of the Production Director for breaking the code of conduct.

(ii) Seek to ensure that the production process is safe and take positive steps to reduce any risk to a minimum.

(iii) Inform the customer of the problem, the action taken, and offer to renegotiate the contract.

(iv) Improve the reporting procedures so that future incidents are brought to the attention of the Board of Directors.

(v) Return to the previous method of production to avoid the possibility of any pollution.

Options

A (i), (ii) and (iii) only

B (ii), (iii) and (v) only

C (iii), (iv) and (v) only

D (i), (ii) and (iv) only

E (i), (iii) and (v) only

Question 2
Which ONE of the following environmental changes is having the MOST significant impact on the performance of the E Company Limited?

A An increase in the degree of competition in the industry is forcing down margins.
B An increase in the bargaining power of buyers in the market.
C Technological developments that provide opportunities to reduce costs.
D The world economy increasing the importance of efficient food production.

Question 3
Which ONE of the following was the MOST significant risk associated with the contract bid?
A The loss of production volumes from losing a contract from a major customer.
B The potential loss of reputation from a reported pollution episode.
C The risk attached to introducing changes to the production process.
D The risk associated with capital investment in the new technology.
E The risk of less developed countries acquiring the capability to produce the chemicals themselves.

Solutions to learning activity:
Question 1 Answer: D
Rationale
This question tests the ability to identify the ethical dimensions behind a business situation. The company operates a code of conduct which the director broke. If the director is seen to go unpunished, the code losses its integrity and force within the company, therefore the director should resign. Therefore element (i) is relevant.

The importance of identifying a problem and ensuring that safeguards are put in place to protect against a reoccurrence is essential and is the subject of element (ii). Directors are obligated to reduce the incident of risk.

In this instance, the customer has not suffered as a consequence and is not concerned about the internal production process as long as the product is safe. The incident is internal and has now been dealt with, the customer could be informed, but there is no obligation to renegotiate the contract as the customer granted the contract on price, rather than safety aspects of the production process, that is, production safety was not a condition of the contract.

As part of governance, the directors should endeavor to ensure that the reporting procedures are improved to safeguard against another breakdown in the system. Element (iv) is relevant.

The problem has been identified, and procedures can now be implemented to ensure that effective monitoring is put in place. There is no evidence that the process is unsafe. Therefore there is no particular need to return to the old method so long as the Directors take action to reduce the level of risk to an acceptable level.

Together elements (i), (ii), and (iv) indicate the most appropriate actions to take.

Question 2 Answer: B
Rationale
Although the scenario includes technological development and the corporate social responsibility issues, the critical factor that is increasing competition and driving down margins is the incidence of increased buyer power in all elements of the industry, that is, not just E Company's customers, but also the customers of the customers, such as Governments.

Question 3 Answer: A
Rationale
The risk to reputation, production, and capital investment can all be controlled to an extent or at least managed. The risk of less developed countries developing the capability themselves is a long-term risk. However, the immediate risk, and the less controllable risk, is the loss of a major contract.