

Risk Management: So Critical, Yet So Elusive

Every good organization around the globe firmly espouses the benefits of sound risk management. Certainly, the recent financial crisis has underscored this imperative. Yet it is remarkable how elusive an effective risk management function can be for many organizations. This is definitely the case for many of the companies we have worked with as part of the corporate governance program in the Middle East and North Africa. This SmartLesson is based on our recent work with an investee company to help put in place a simple but effective enterprise risk management process. This work was part of a wider corporate governance improvement effort for the company. It also draws on experiences we've had with other companies and provides lessons for any organization trying to figure out how to actually make risk management work.

BACKGROUND

This particular client, a mid-size, private manufacturing sector company in the Middle East and North Africa region, still operated as a small, closely-held company. It had essentially outgrown its current infrastructure, including many of its management control functions. As with many companies of this nature, there was no formal risk management framework in place. The client noted that managers considered risks implicitly as part of their day-to-day operations and addressed issues reactively as they occurred. It also mentioned that a risk assessment had been conducted in the past year by an outside advisor and delivered in a written report to the company. The challenge for this client was to help design an effective risk management function that had the following characteristics critical to its success:

- Embedded throughout the organization, not just at senior levels and not just in the financial processes but also in project operations, where much of the risk lies
- Routine and used as a real management tool, not just as a check-the-box reporting exercise
- Promoting ongoing, timely dialogue regarding risks facing the organization

LESSONS LEARNED

It should be noted that the client is still in the process of fully implementing the recommendations described below. This is to be expected, given the enterprise-wide scope of the effort. Nevertheless, several immediate and important lessons can be drawn from this experience.

1) Focus on the process and keep it simple.

The primary focus should be on the process. While it's important to have a firm understanding of risk management concepts, tools, and techniques, the key consideration should be: how does a company actually put in place a working process for discussing risk on an ongoing basis? For this client, we considered the following:

- What risk-related information is being collected?
- What is the flow of that information in the organization?
- What dialogue is the information supporting?
- How frequent is the dialogue?
- Who in the organization is having the dialogue?
- What actions and decisions is the dialogue informing?

These considerations helped shape the design of the risk management processes for this client. Another lesson is to keep the process simple enough that managers use it and take it seriously—that is, make it stick. This was especially important for this client, since it had previously tried different approaches, none of which were sustained. Unnecessarily complex processes can be counterproductive. For example, we observed processes in other clients that require managers to complete a long series of reports and forms that go into excruciating detail about their risks and mitigation strategies. They require so much effort that managers do not use them as an effective management tool—rather, they are just a burdensome reporting exercise for senior management. We were careful to avoid that for this client.

Ultimately, the process we recommended for this client did not employ any new concepts. Rather, we distilled common risk management concepts down to a simple form to create an easy-to-use process. One of the main tricks was to figure out how we could integrate the risk dialogue into the client's existing planning and performance-monitoring processes. So, rather than create a completely separate risk management process,

BOX 1: RISK MANAGEMENT—HOW THE TERM IS USED

Risk management means different things to different companies. Some companies point to a detailed risk assessment report, conducted annually, as their form of risk management. Others point to dedicated risk management staff that focus on monitoring risks for the organization, sometimes using sophisticated risk models. Here, we are talking about overall **enterprise risk management**, relating to the processes in place throughout a company to continually assess potential risks and take actions accordingly to help manage those risks and achieve defined business objectives. The scope includes any type of risk—internal and external—facing the company at all levels of the organization. This is the bedrock of any company's management control environment and, hence, its corporate governance framework.

we simply tied it to the client's existing management activities, such as biweekly executive committee meetings and ongoing unit-level status meetings (see Box 2 for process highlights).

2) Integrate risk management with other key management control processes.

In the past, this client treated risk management as a separate, periodic process conducted by particular individuals and an outside advisor. We illustrated how risk management can be linked to other key management functions to create a seamless, continual process for controlling the organization (see Figure 1). We highlighted the following:

- **Integration with business planning.** Risks should be identified for all strategic initiatives based on the company's business plans (which, fortunately, were well-developed for this client) and, ultimately, made part of the plans themselves.
- **Integration with performance monitoring.** Risks and the mitigation actions should be reported and monitored as part of the company's routine performance-monitoring processes, just as with other types of performance information (such as financial performance, project performance). These reviews should be continual and should feed back into the planning cycle on an ongoing basis.
- **Integration with internal control.** Control activities for the organization should be linked to the specific risks identified. The same matrices used to identify and assess risks can then be used to identify the control activity (or mitigating action, depending on the nature of the risk), to ensure that the internal control framework is risk-based.
- **Integration with internal audit.** The internal audit function, which did not exist prior to the corporate governance review, should assess the entire risk management and control framework to ensure that it is working effectively. The

BOX 2: HIGHLIGHTS OF THE RECOMMENDED RISK MANAGEMENT PROCESS FOR THE CLIENT

- Given the defined strategic initiatives from the company's business plans, define the corresponding risks for each by considering: What can go wrong?
- The risks should include all types of risks, both internal and external.
- For each risk, rate (on a scale of 1 to 10) the likely impact and probability of each. Then use the combined ratings to assign an overall priority rating, for instance the higher the impact and probability, the higher the priority.
- Identify mitigation action(s) for each risk, and assign responsibility. This will depend on the risk appetite. For example, low-priority risks may not require much, if any, mitigation.
- Provide biweekly updates to the executive committee alongside other performance reports. The risks and mitigating actions are no different from other strategic initiatives that should be constantly monitored. Consider a scorecard approach that assigns qualitative progress indicators.
- A risk matrix such as this should be completed for each business unit and also at the overall enterprise level. This matrix can be cascaded down into the business units and integrated with their monitoring and reporting activities.

assigned risk priorities can help ensure that the internal audit program is risk-based, focusing on the highest-priority risks and controls.

3) *It's all about the dialogue.*

Simply put, if the right risk dialogue is not happening, the process is broken. Whatever form the risk management process ultimately takes in an organization, it must be facilitating a routine, useful dialogue about risk throughout the enterprise. For this client, most of the risk-related dialogue was reactive, addressing particular issues after they surfaced. Further, it was mostly bilateral between the chief executive officer and the relevant manager and

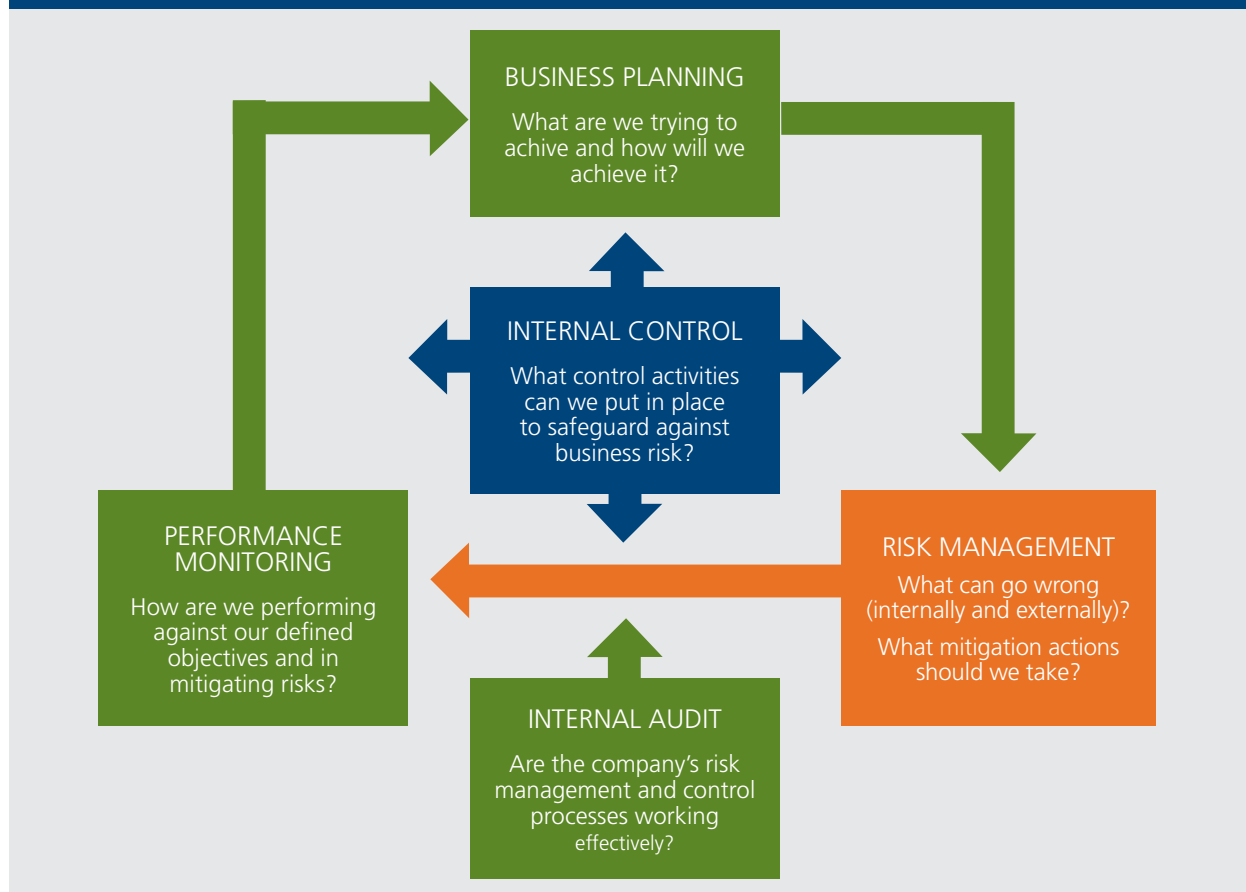
not considered in a structured way. We suggested the following to help improve the dialogue:

- **Encourage transparency.** The dialogue should encourage candid reporting by staff so as to promote organizational transparency and useful management actions.
- **Consider all types of risks.** The dialogue should not focus only on financial risk, as is common. It should consider all types of risk, both internal—operational, financial—and external—market, political—that may inhibit achievement of the company's strategic objectives.
- **Challenge assumptions.** Discussions should challenge underlying assumptions, such as those about the probability or impact of particular risks. Every strategic initiative has a potential downside that needs to be discussed.
- **Have measured responses.** Not every risk identified will require a corresponding mitigating action. There is a cost and benefit to be considered for each. The risk appetite should drive the appropriate mitigation strategies.
- **Be proactive.** Do not let discussions focus solely on reacting to recent issues; rather, push managers to be forward-looking and to try to anticipate risks that may occur in the short term and even longer term on a continuing basis.
- **Demand stress-testing.** Consider extreme or worst-case scenarios and the likely impact. Consider a variety of scenarios and not just business as usual. This is especially critical in today's environment.
- **Become second nature.** Reinforce the notion that any performance or strategic discussions should automatically include risk dialogue, so that it becomes second nature for staff to constantly consider: What can go wrong?

4) *The board has a key role.*

From a governance perspective, the board of directors should have an effective challenge function in risk

FIGURE 1: INTEGRATING RISK MANAGEMENT WITH OTHER KEY MANAGEMENT CONTROL FUNCTIONS



discussions. One of the major benefits of having a well-functioning, diverse board (as we promote for good corporate governance) is its ability to offer different perspectives on discussions about strategy and risk and to effectively challenge management. Therefore, the process should be designed to ensure that the board is receiving the right information and having the right dialogue about the risks facing the company. We emphasized this point to the client and included it as one of the key responsibilities for the board audit committee.

CONCLUSION

Risk management concepts will continue to evolve, especially in response to the current financial crisis gripping companies around the world. Yet, in our

experience, the most value-added advice we can offer to our clients is not only to help them understand risk management concepts as they evolve, but also to offer practical lessons on how to actually make them work.

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