Horwath Clark Whitehill

Looking around corners – refreshing risk management

by Pesh Framjee, Horwath Clark Whitehill

Risk management has been around for some time and now organisations are looking for ways to get greater value out of the process. Some are disillusioned and are questioning the value of risk management. I am often asked whether there were any risk registers out there that identified, at a sufficiently early stage, the risk of the position that many charities see themselves in now. The answer is that I certainly did not see them but without doubt if most of my clients did not have the risk management procedure in place that they do have they would be in a worse position.

That is not to say that we should be complacent about the process and it is important to recognise that risk management has moved on and fresh thinking is needed.

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Value creation

New thinking focuses on the concepts of rewarded and unrewarded risks. Some risks are all downside and no upside. For example, if a charity fails to comply with laws and regulations there can be significant consequences, but there is no extra credit for being even more compliant. Similarly, it is important to avoid disruptions to critical operations and systems, but doing so simply meets expectations rather than being seen as something that deserves reward. These are the unrewarded risks. They cannot be ignored, but the primary incentive for dealing with them is value protection.

Other risks are about upside, for example, introducing new innovations in service delivery or expanding into new areas of income generation. The primary reason for taking these risks is to add value. Yes, taking these risks might have a downside but the potential upside is greater. In my experience the charities that succeed are not the ones that avoid risk but are those that look for opportunities and, fully understanding their risk appetite, take risks only after carefully considering them and seeing how they help to create value.

Most risk registers I see focus on compliance issues and what could go wrong with the things that a charity is doing. Value protection risks are important but the issue is that individuals may focus the bulk of their attention on the threats and end up missing out on the opportunities. Risk management often falls within the remit of the finance director or the internal auditor with oversight from the audit committee or the trustees. These individuals are usually naturally cautious and therefore in the past many charities have tended to focus on unrewarded value protection. Ensuring that operations and resources are sustainable is becoming more difficult so there is now greater need to look out for missed opportunities and many charities are recognising that the focus should shift to value creation. Risk aversion and focusing only on downside can lead to underinvestment in the kinds of opportunities that drive growth and create value for stakeholders. Risk intelligent organisations understand this and respond accordingly.

Along with the change of mindset there is perhaps a need to revisit some of the thinking on methodology.

A fresh look at risk scoring

Traditional risk scoring methodology focused on considering both impact and likelihood or probability of a risk and giving them equal importance.

In this thinking the impact score is usually multiplied by the score for likelihood and the product of the scores used to rank risks. Therefore with a scoring system of say 1-5 a risk that has been assessed as very high in both likelihood and impact will have a score of 25 (5x5). A risk that has a very high impact but a very low likelihood will have a risk score of 5 (5x1) as will a risk with very high likelihood and very low impact. This is however problematic as it makes people allocate risk management resources in a questionable manner.

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I think there is widespread acceptance that a risk which has very high impact and very low likelihood should have greater importance than one with very high likelihood and insignificant impact. Also, most risk registers show the gross risk, the risk that is inherent and then the net or residual risk (the risk that still exists after the controls and risk mitigation are considered). In my experience the key change between gross and net risk is usually in reducing the likelihood score. However, the traditional scoring does not reflect this and gives equal emphasis to impact and likelihood.

This is the methodology that has been popular in the past and the approach described by the Charity Commission and many of the other discussions on risk methodology used in the charity sector.

The thinking has moved on and there is greater recognition that probability has less value for risks that occur outside the norm. This means that approaches will have to be incorporated to deal with a new financial climate and new challenges. Risk management needs an overhaul especially when events are rare or unprecedented; where the rules are unknown or rapidly changing; or where risks are driven by external factors beyond the organisation's control. In such instances, the concept of vulnerability and risk interaction should assume prominence in both the risk assessment and risk management processes.

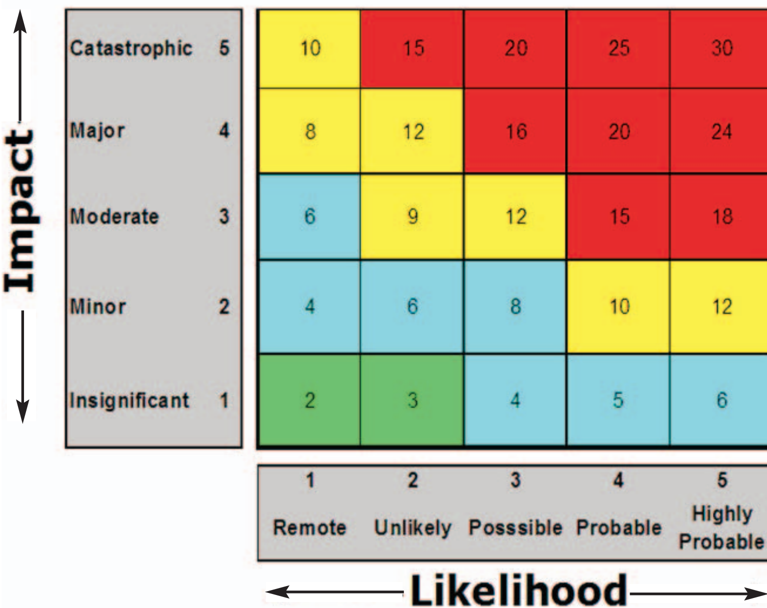
If an organisation is vulnerable to a risk that is both relevant and has extremely high impact, it should be addressed, regardless of "remote" likelihood. However, risk appetite needs to be factored in and "addressed" in this context, is not necessarily the same as "mitigated." A balance needs to be attained and vulnerability should be weighed alongside probability whilst recognising that sometimes improbable events do occur with devastating effect, while other times probable events fail to materialise. This means that there is a much greater need to understand the possible, and its impact, and not just the probable.

By this I am not advocating a methodology that leads to a risk register that is voluminous, listing every possible risk and failing to deliver real risk management benefits. Resource constraints, risks and rewards and risk appetite need to be considered.

Organisations that focus only on big risks may find themselves ill-prepared to face the interaction of separate adverse events

Likelihood does play an important part in scoring but impact needs to be given greater weight. The heat map below shows how using the 1-5 scores to give a greater weighting to impact can be applied. This works on a scoring of xy+y where x is likelihood and y is impact.

Some practitioners give even more importance to impact and use a scoring methodology of xy+2y.



Heat map showing the relationship between impact and likelihood based on a scoring of (impact x likelihood) + impact

Risk Contagion and risk cascades

Notwithstanding the importance of focusing on high impact risks there is need for careful consideration of linked risks and the "domino" effect. Most major value losses involve the interaction of more than one risk. Many catastrophic losses are the result of a series of small events rather than a single large event. Unfortunately, organisations that focus only on big risks may find themselves ill-prepared to face the interaction of separate adverse events in the absence of an integrated and coordinated response to linked risks. Similarly, the exposure to a portfolio of risks needs to be considered.

An isolated concentration on value at risk can sometimes result in not spotting 'risk contagion' – in other words where one low impact risk leads to another and another so that the cumulative impact is catastrophic.

At the same time, risks that are off the radar can lead to problems. For example charities that are not involved with public service delivery and do not get their funding from government and / or local authorities seem to think that cuts in public spending will not impact them. However, when I speak to charities that are involved in public service delivery, they having recognised that this income is under threat, have geared up their fund raising efforts in other areas. This can and will have a cascading effect on other charities.

Most organisations focus on the most direct risks and those that they believe have high likelihood of occurring. This is important but the revelance of focusing on high value risks and how risks interact with one another and how more remote risks cascade to have greater impact can not be ignored. We have to accept that risk assessment methods will often fail to forsee or manage all critical risks. Nevertheless, refreshing the way we approach risk management and understanding how risks develop and interact will help ensure that the organisation is as well prepared as it can be.

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