

## Effective risk management - back to basics by Marinus de Pooter of Ernst & Young



The credit crunch has brought the financial sector to the centre of media attention. This sector that spends many millions of euros on risk management had to report write-offs and losses amounting to many billions. How much more disturbing can things become?

In this article I want to set out the basics of risk management and the application thereof in practice. The approach outlined below can be applied to any level (e.g. division, location, department, project), not only in the business world, but also within governmental organisations, regions and municipalities.

### Risk management – what it is all about

'Risks' are future events that could hamper the realization of organisational objectives. Similarly, 'opportunities' are future events that could help the realization of those objectives. Without proper clarification of the scope and the objectives, effective risk management becomes hard to achieve. The risks and controls need to be identified and prioritized. Responsible management also needs to assess if those risks are at acceptable levels and if the organisation is sufficiently equipped to seize opportunities. This is the 'design effectiveness' assessment. In other words asking: "Are we doing the right things?" To the extent that is not the case, management needs to implement additional or improved controls. Last but not least, management needs to establish that the controls work as intended. In other words they should ask: "Are we doing (the agreed) things right?" This is the 'operational effectiveness' assessment. The evaluation of the design and operational effectiveness forms the basis for the conclusion whether the organisation is 'in control' or not.

### 'Value management' – a better term

Enterprise Risk Management ('ERM') is an organisation-wide process to identify potential events that might impact the realization of organisational objectives. In order to ensure that the risks remain within the desired risk profile(s), measures are required to ensure that the objectives are achieved. Historically, risk management approaches the future from a negative angle: a variety of unpleasant things may happen that should be avoided. Consequently, risk management and performance management were considered to be separate worlds until recently. However, both profit and non-profit organisations can benefit from a more integrated approach. The latter could be labelled 'value management', i.e. creating and preserving value (or: enabling and protecting performance) within the organisation.

### Internal control – unique for every organisation

Internal control is inextricably linked with value management. At the heart of internal control is the aggregate of



measures ('controls') that management takes in order to ensure that certain objectives are realized. As every organisation has its own culture and every situation is unique, value management and internal control vary by entity. Differences relate to: the expectations of the stakeholders, the maturity of the organisation, the risk appetite of management, etc. In practice, value management often takes place in more implicit ways, e.g. when making investment decisions, when selecting suppliers, hiring employees, etc. Usually, the analyses are performed by separate functions or departments familiar with specific risk categories, e.g. IT, Treasury, Health & Safety, Finance & Controlling, Quality, Business Continuity, etc. Therefore, it is quite common that a variety of separate, mostly independent, risk management systems exists, implemented for historical reasons and usually driven by regulators.

## **Implementing value management in practice**

Good value management can help management at all levels to achieve their objectives and meet expectations. Those objectives are aimed at creating and preserving value for their stakeholders, such as: citizens, employees, other governmental agencies, regulators, financiers, neighbours, etc. In order to achieve those objectives, managers need take measures within their areas of responsibility. Those measures are known within the organisation as the "rules of the house", such as: charters, policies, protocols, procedures, instructions, manuals, etc. Basically, internal control comes down to ensuring that there are adequate 'rules of the house' and that they

work as intended. Those rules (both in writing and verbal) are intended to steer the behaviour of the employees in the direction chosen by management. Rules have been implemented in the course of time and sometimes maintained poorly due to cutbacks in expenditure, the departure of employees, reorganisations, changes in processes, etc. Factors like these make it hard for management in charge to keep an overview of their own rules. This in turn can lead to situations that conflicting rules are issued, causing confusion for the employees. That is why the 'governance' of these rules is so important. In addition, this governance is essential to avoid an excessive 'control burden' by balancing costs and efforts of controls versus the reduction of risk exposure.

## **Achieving effective internal control**

The following steps are important to get and stay 'in control'. They can be applied to every responsibility area within an organisation.

1. Clarify the objectives, aimed at creating and preserving value for the stakeholders. In addition, determine the extent of acceptable deviation ('risk appetite' or 'control ambition').
2. Analyze which future events could hamper (risks) or help (opportunities) the achievement of the organisational objectives.
3. Inventory and document the current controls, aimed at ensuring the realization of the objectives.
4. Determine whether the current controls are adequate to ensure that the deviations of the desired results are within acceptable limits. In addition, decide which controls need to be implemented or improved and which ones are redundant.
5. Properly document and communicate the 'rules of the house', so that





those responsible know what is expected from them and implement the necessary modifications.

6. Monitor whether the 'rules of the house' are being followed through daily management supervision, peer reviews, control self-assessments, (internal and external) audits, inspections, etc.
7. Evaluate to which extent the objectives are realized and which internal control improvements are required. This evaluation is the basis for the risk management reporting to the oversight functions.

## Finding the right balance

Value management is rather art than science. It is about management's competences to deal with the uncertain future. It requires a lot of judgement, e.g. about what the stakeholders really want, what the likelihood and effects of the risks and opportunities are, what the adequacy and effectiveness are of the measures taken by management, balancing costs and benefits. And particularly, judgement regarding balancing the perceived and the desired (i.e. based on the risk appetite) risk profiles.

## Ownership is key

It is the role of top management to define the areas of responsibility for each of the functions within the organisation. Effective value management requires clear setting, cascading and communication of objectives. Processes and initiatives exist to realize these objectives in practice. It must be clear to the process owner, usually line management of an organisational entity, what are the requirements, stipulated by third parties (e.g. governmental and regulatory agencies) versus the matters that are left to the discretion of local management. Each process 'owner' then needs to determine which controls are suitable, in

view of the perceived risks, cost-benefit considerations, etc. Last but not least (s) he also needs to monitor if the quality of the business process or initiative is within acceptable tolerances. Based on that (s) he can then report on the status of 'in control'.

## Explicitly deciding about the 'rules of the house'

Deliberately deciding not to stipulate 'rules of the house' implies that the directing and controlling of the situation is left to the own judgement of management in charge. The benefits of the freedom to make decisions locally can outweigh the benefits of centralization and standardization. Examples include: selection of suppliers, employee, background checks, flexible office hours, teleworking, salary ranges, internet usage, etc.

Many organisations struggle with making their internal rules specific, transparent, accessible, etc. This includes questions such as:

- a. Who can issue which 'rules of the house' and how often?
- b. Are our rules clear for the intended audience and mutually consistent?
- c. Have our rules been documented in ways that facilitate maintenance in the future?
- d. Are our rules updated on a timely basis?
- e. Do we have too many rules?
- f. Can we leave more at the discretion of our managers and employees?
- g. Are our internal rules sufficiently transparent for our regulators?

It is recommended to use the organisation's intranet as the one stop repository for all the 'rules of the house'. That infrastructure will also facilitate accessibility and regular updates of all relevant rules.

## Successful value management

Several key aspects of the organisation's culture and management reporting appear to be powerful enablers of successful value management in practice. They include:

1. The univocal support of top management and their attitude (underscoring the importance of internal control, making people feel responsible for it, walking their own talk, dealing with resistance where needed, punishing those who violate the 'rules of the house', etc.).
2. The allocation of responsibilities for the realization of objectives, hence also for managing the related risks and opportunities. Clearly linking risk categories to responsibilities within the organisation avoids gaps, overlaps and inconsistencies in risk coverage. Gaps can arise, when e.g. everyone assumes that somebody else takes care of managing a given risk.
3. Including key indicators (e.g. performance or risk indicators) in the existing management reporting appears to be a very effective way to inform those responsible for achieving the objectives about the quality of the business processes. Defining bandwidths to objectives ('risk tolerances') can be used to apply the concept of 'risk appetite' in practice.

## A key lesson learned from the credit crunch

Value management is all about human behaviour and capabilities. Behaviour is only predictable to a certain extent. It is also influenced by factors such as: greed, herd reflexes, short term focus, incomplete information, limited judgement, etc. Applying the approach outlined in this article can help those in charge to create and preserve value for their organisations in practice.