Risk Management—Setting Priorities by Likelihood and Impact

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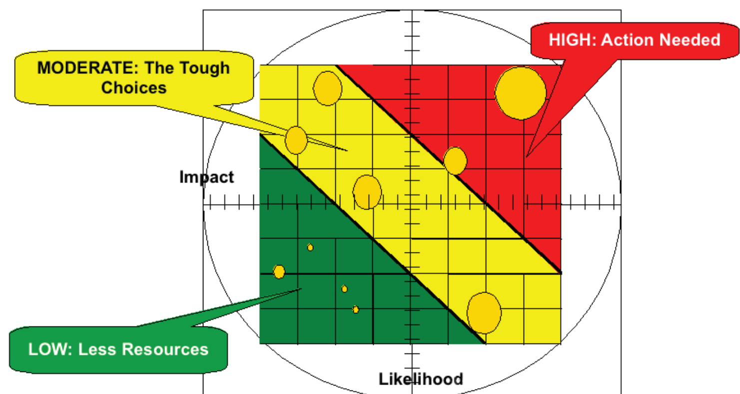
This essay is part of a series, *Controllers' Corner: Two-Minute Essays on Financial Management and Control*, which asks industry thought leaders for their opinions on critical issues facing today's finance organizations.

The worldwide economic crisis has been blamed in part on failures of regulatory oversight, corporate governance, and risk management. As organizations prepare for a return to growth, they are asking themselves how to prepare their governance, risk, and compliance profiles for the next set of unexpected events.

Q. **Given that governance, risk and compliance (GRC) covers a broad range of processes, how should organizations set their priorities for risk management?**

Most organizations prioritize risk based on some combination of likelihood and impact, with those perceived as high in both dimensions being given the highest priority. The difficulty of course lies in assigning the correct priority to those risks seen as high in one dimension but low in the other. The typical result in such cases is some 'middling' placement on a typical risk map, such as the one shown below.



A typical risk map plots likelihood and impact.

An equal consideration when prioritizing risk is the degree of independence of a given risk. At one extreme is the stand-alone risk, which can be assessed and actions taken essentially in isolation. But these circumstances are rare indeed. At the other extreme are risks that are closely correlated with others, thus spawning a web-like network of actions and reactions. At a minimum, organizations must seek to identify which plausible combinations of events could cause serious adverse consequences, and then identify actions that might prevent or mitigate more than one risk.

Unfortunately, most traditional risk management approaches overlook one key factor: management's ability—or lack of it—to influence or control either the impact or likelihood of a given risk. Consider at one end of the spectrum a natural disaster. Management has no ability to influence the likelihood of such an event and therefore all of its efforts must be focused on impact mitigation, an area in which management likely has substantial influence. Conversely, fraud may be viewed through the opposite lens. Management has substantial influence over the likelihood of fraud, largely through internal controls, but relatively less influence over the impact. The benefit of this approach is that it can deliver 'quick wins' – the mitigation of risks that can be managed with relative ease while avoiding the waste of resources against those risks that cannot be prevented or mitigated ahead of time.

There are a number of risk domains in which a Finance Director or Corporate/Business Unit Controller can provide leadership and expertise, as shown in the schematic below. The most obvious, of course, is assuring that the organization is fully compliant with external accounting and reporting regulations and standards, which we describe below as one key element of having a license to do business. Building on that foundation, Controllers and Finance Directors must also ensure appropriate adherence to internal accounting and financial control policies and procedures.

But these should not be as hard and fast as external laws and regulations, where non-compliance is simply not an option. Internal policies and procedures should be subject to managerial and employee judgment – the very characteristic for which most employees are hired – based on specific business circumstances, rather than forcing blind adherence, which often leads to compliance with the letter of the policy but not the spirit.

The middle two levels of the pyramid represent the application of, respectively, ethical standards and principles by financial executives, particularly in regards to external disclosure of financial results and other information; and the exercise of judgment over managerial decisions. In the former case, the question is usually guided by principles and the fundamental question of "economic reality." However, the latter is much more difficult since there is no up-front "right" answer.

Risk domains.

For example, Finance Directors are often asked to assess alternatives and recommend the best course of action with regards to payment terms in a contract, lease versus buy situations, and revenue recognition policies relative to contractual terms. In most of these cases, there is no absolute 'best' answer, but rather a trade-off between the pros and cons of each alternative. Senior financial executives should be less concerned with the answer than with ensuring that a reasonable process of risk assessment and analysis is followed.

In summary, senior finance executives can often act as the moral compass of the organization, but in doing so they should take care to ensure that their peers and colleagues retain the authority to adjust internal policies and practices to suit business requirements. Agility and flexibility are often the hallmarks of successful risk management.

About Robert Torok

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