Risk Management and Improvement

Introduction

Managing risk is an essential part of all professions. All professional and business activity involves a degree of risk. It is a vital element of professional duty to be alert to the risks that exist, and to minimise them to the greatest degree possible. However, risk cannot be eliminated entirely, and the risk involved in any endeavour need to be carefully gauged. The alternative would be to do nothing because of the risk involved and this would engender further and perhaps more serious risks. For example, a professional practice that refuses to engage with many new business opportunities because of the heightened risk involved, could find in time that the practice was failing because it was not developing new capabilities.

This article on risk management and improvement outlines the essential elements of risk management, and how the management or risk needs to become part of organisational processes. The universality of risk in organisational life is considered, and the many kinds of risk that exist. Key areas of risk are highlighted and the wide scope of internal and external risks. How to identify risks is considered, and the consequences of ignoring risks illustrated.

While many of the experiences of risk management from which the following material is drawn come from corporate experience, there are many reasons why the same insights and risk management routines apply to professional firms and businesses. Firstly, many professional firms are very large, are global and are incorporated, some even stock exchange listed. Increasingly, the management of risks involved in their work and enterprise are parallel with industrial and financial firms. Second, while once professionals and their associations were self-regulating and had an ethos of autonomy, many professions are now subject to extensive regulatory regimes. In this way too, the regulatory or legal risk of professional firms and individuals, is little different to those of non-professionals. Third, even if professional firms are small or sole practices, understanding and managing professional and business risks, gives a more sustainable outcome for clients, the proprietors and the future of a professional practice. Finally, occupations (some in the financial sector) see professions and greater professionalism as a standard of conduct and competence to aspire to. For the reasons elaborated below, this should include robust and appropriate risk management, including in relation to the ethics which distinguish a profession, or should do so.

Essential Elements of Risk Management

Risk management is integral to all professional roles. When things go badly wrong, or businesses fail, too often it is discovered that the professional management had never seriously contemplated any risk assessment. Conducting professional risk management involves some basic steps:

- Assessing the nature and extent of the risks facing the organization or company;
- The extent and categories of risk which management regards as acceptable for the company to bear (sometimes referred to as the risk appetite);

- The likelihood of the risks concerned materializing (relating likelihood to the magnitude of the specific risks);
- The company's ability to reduce the incidence and impact on the business of risks that do materialise (seeking to minimise as far as possible the major risks); and
- The costs of operating controls relative to the benefit thereby obtained in managing the related risks (while significant investment in risk management may be required, some risks may be too expensive to remedy before rather than after the event).

It is important that the system of risk management:

- Is embedded in the operations of the company and form part of its culture;
- Can respond quickly to evolving risks to the organization or individuals from factors within the company and to changes in the organizational environment; and
- Include procedures for reporting immediately to appropriate professionals or levels of management any significant risk management failings or weaknesses that are identified together with details of corrective action being undertaken.

A sound system of risk management significantly reduces, but cannot eradicate, the possibility of poor judgement in decision-making; human error; risk management processes being deliberately circumvented by employees and others; management overriding controls; and the occurrence of unforeseeable difficult or dangerous circumstances.

Universal Risk in Professional Practice and the Business Cycle

The fact is that risk is universal and constant in professional practice, the business cycle (and in everyday life, even riding your bicycle involves a degree of risk). In the professions and in business what is challenging to manage is the great variety of sources of risk, and the fact these keep changing, and as soon as one risk diminishes in immediacy, another rises from a very different and unanticipated quarter. This is part of the complexity and speed of modern organisational life, and though we have sophisticated new information systems to help manage this systemic increase in the degree of risk, too often it is a fault in information systems that cause the risk!

The panoply of risks ranges across organisational and business risk, legislative and regulatory risk, people risk, and disaster risk. The key risk areas are listed in Table 1; however, this array of risks could be added to considerably with reference to any professional or activity. Indeed, mapping out the extent and detail of the risks faced by any organisation is a significant task, which should not be underestimated.

Table 1: Key Risk Areas

Business risk	Legislative risk	People risk	Disaster risk
• Asset management and resource planning • Business interruption • Client relations • Change: organisational/ technical/political • Construction activity • Feasibility studies • Foreign exchange operations • Information systems/ computer networks • Investments • Operations and maintenance systems • Transport (air, sea, road, rail) • Project management • Purchasing contract management • Treasury and finance	• Design and product liability • Directors' and officers' liability • Employment procedures, training, discrimination and harassment • Environmental issues • Fraud prevention/detection/ management • Legislative requirements • Occupational health and safety • Public risk and general liability	• Ethics and probity issues • Human, animal and plant health • Professional advice • Reputation and image issues • Security	• Contingency, disaster and emergency planning • Fire detection/fire prevention

Source: Adapted from data in Standards Australia, *Risk Management: Australian/New Zealand Standard* (1999)

Risks exist at all stages in organisational life and development and the business cycle. However, in good times when everything appears to be running well, organisations often become more relaxed about potential risks as confidence grows. The relaxing or even abandonment of risk management in the circumstances where everything seems under control can be dangerous. Organisational failure often occurs without due warning from the risk management or control system because it is not fully functioning at the time. As the UK Financial Reporting Council insists:

> Establishing an effective system of internal control is not a one-off exercise. No such system remains effective unless it develops to take account of new and emerging risks, control failures, market expectations or changes in the company's circumstances or business objectives. The Review Group reiterates the view of most respondents in emphasising the importance of regular and systematic assessment of the risks facing the business and the value of embedding risk management and internal control systems within business processes. It is the board's responsibility to make sure this happens.[1]

Figure 1: The Scope of Risk Management

Source: Adapted from R Anderson and Associates, cited in OECD, *Risk Management and Corporate Governance Report (2013)*

[1] Financial Reporting Council, *Internal Control – Revised Guidelines for Directors on the Combined Code* (2005) 3.

Identifying Risks

The sources and scale of risk range from operating risk that is a daily concern, to more strategic risks, both of which can be controlled more directly to a degree by careful risk management (Figure 1). Compliance risk is more of an externally controlled risk that organisations must remain vigilant in observing. Finally, disasters are the greatest risks of all, however adequate preparations are helpful, and it is incumbent on companies not to create their own disasters as BP did in the Deepwater drilling well explosion in 2010, argued to be the largest man-made natural disaster that cost the corporation more than US$ 54 billion to settle. A UC Berkeley study stated: 'This disaster was preventable had existing progressive guidelines and practices been followed. This catastrophic failure appears to have resulted from multiple violations of the laws of public resource development, and its proper regulatory oversight'. The report further stated: 'These failures (to contain, control, mitigate, plan, and clean-up) appear to be deeply rooted in a multi-decade history of organizational malfunction and short-sightedness'.[2]

In another case of a hitherto highly respected international company confronting disaster because of its neglect and defiance towards vital risk management and essential environmental standards, in September 2015, VW admitted to installing software in 11 million car engines over several years that allowed the cars to pass regulators laboratory emissions tests but belched out toxic nitrogen oxides when travelling normally on the road. As VW faced a litany of fines, lawsuits and recall costs involving tens of billions of dollars, its reputation for engineering excellence and environmental responsibility was the severely damaged.[3]

The World Economic Forum reviews the most common types of risk in terms of the external market and the internal organization (Figure 2). These are all operational risks that can impact upon the organisation without warning, and therefore must be prepared for in advance. For each organisation the magnitude of the risk involved from specific causes will vary considerably, and the assessment of the potential impact of risks needs to be carefully calibrated. For example, the greatest operational risks in health, finance, manufacturing, and transport industries are likely to be very different, though each of these industries will face risks in common also.

One illustration of a universal risk is occupational health and safety. Historically it was once the case that frequent illness, injury and even death was associated with certain industries and occupations, for example mining, building, or chemical processing industries. A lengthy campaign against avoidable injuries, together with increasingly severe regulation with heavy penalties for employers who neglected health and safety, has dramatically reduced the incidence of industrial injury in the advanced industrial world.

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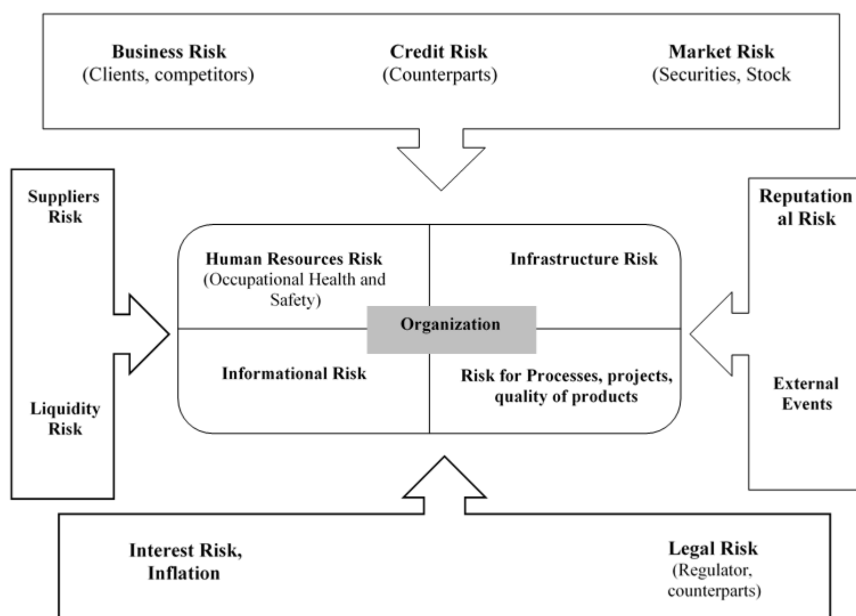
[2] Deepwater Horizon Study Group, *Final Report on the Investigation of the Maconda Well Blowout* (Centre for Catastrophic Risk Management, University of California Berkeley, 1 March 2011) 5 <http://ccrm.berkeley.edu/pdfs_papers/bea_pdfs/dhsgfinalreport-march2011-tag.pdf> (accessed 9 August 2017).
[3] V Bryan, and N Potter, 'Factbox: Timeline of VW auto emissions scandal', *Reuters* (online), 3 March 2016 <http://www.reuters.com/article/us-volkswagen-emissions-factbox-idUSKCN0W518W> (accessed 9 August 2017).

Figure 2: Various Types of Operational Risks



Source: Adapted from: World Economic Forum, *Global Risks* (2012)

What Happens When Risks are Not Managed?

It is always tempting to minimise the possibility of serious risks arising when everything appears to be going extremely well. It is acceptable to highlight risks when they are evidently occurring all around you, but it is much harder to stress the importance of risk management when all the signs are favourable for expanding the business. This phenomenon of executives marginalising risk is something that has been in evidence in the international financial industries recurrently in recent times. It was the sense of euphoria in the early 2000s with how revenues and profits of the international banks were expanding exponentially (what Alan Greenspan the chair of the Federal Reserve in the United States once referred to as irrational exuberance) that disarmed risk management in many financial institutions and left them totally exposed to the ravages of the global financial crisis when it occurred in 2007/2008.

Financial businesses activities in rapidly changing markets are highly sensitive to variance and it might be expected that, as the financial services industries have grown inexorably and financial products become more complex, the sophistication of risk management techniques will have been developed in parallel. However, the most widely employed risk management tool at the time of the financial crisis was value-at-risk ('VaR'), which measures portfolio risk under most market conditions. However, this measure ignores what might happen now of greatest risk: at the tail of the distribution when the bank is facing the greatest risk. For example, UBS was the European bank with the largest losses from the crisis, involving the Swiss government and central bank providing an aid package of $59.2 billion to take risky debt securities from its balance sheet. In a report to shareholders published in April 2008, UBS laid bare the risk management failings that had led to such immense losses.[4]

[4] UBS, *Shareholder Report on UBS's Write Downs* (2008) (accessed 15 August 2017).

More recently, in the finance sector in Australia, the big four banks, at a time when they were all doing exceedingly well in terms of their revenues and profits, have frequently been found not to exercise vigilant enough risk management. This has resulted in unnecessary damage being incurred both to the reputation of the banks and in the relationship of trust with their customers. To take one example from many, the CBA was performing the best of the big four banks financially in the years 2012 to 2017. However, it was damaged by a series of risk management failures in its service delivery, culminating in a reference by the financial regulator Austrac to the Federal Court regarding more than 53,000 ATM transactions amounting to a total of $625 million of suspicious transactions. Though the CBA denied these charges, it did appear that the risk management of the bank was slow to resolve this problem.

Summary

Risk management is key to the successful operation of any profession or business organisation. Risk is constant and cannot be ignored or wished away. Risk must be managed. Professionals and managers need to alert to the risks that exist, to gauge their immediacy and potential impact, and to take all the necessary measures to minimise risk. The capacity to identify risks and to fully understand the wide range of potential risks is an important part of the skillset of professional managers.

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This subject overview has been written with the support of the following partners:

Australian Government
Australian Research Council

UNSW
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CLMR
Centre for Law, Markets and Regulation