THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND & WALES

Risk management for SMEs

October 2002

A briefing document from The Faculty of Finance and Management of The Institute of Chartered Accountants in England & Wales

‘Risk management is now a core business process’

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Introduction

The Institute is taking a leading role in promoting the discipline that companies should report on their major business risks and on how management deals with them.

In June 2002, we published *No surprises: Working for better risk reporting*. This summarised the thinking behind the Institute's stance on risk reporting and explained why companies, shareholders and other stakeholders would be better served by the provision of risk-related information.

This document aims to establish good practice for the management of risk, particularly among small and medium-sized enterprises (SMEs).

As previous papers have acknowledged, the dual objectives of good risk management and good risk reporting reinforce each other. An integrated risk management process should lead on to better risk reporting without additional procedures. This will result in better management of risks and better sharing of risk-related information.

Although the words 'company' and 'shareholder' are used throughout the text, the principles outlined below will apply to all organisations large or small, including non-listed companies and the not-for-profit sector.

This briefing summarises the work of recent research undertaken by the Institute's Faculty of Finance and Management. The full document, consisting of a guide to recent thinking in the area of risk management and an overview of the issues to consider when putting together a risk management strategy, is available on the Institute's risk web site

www.icaew.co.uk/risk

Risk management for SMEs

1. The importance of business risk

1.1 A string of large and highly public corporate failures over the past 10 to 15 years has focused investors' and regulators' attention worldwide on the way in which company directors and managers are managing risk. Many companies have focused on value creation as a key goal. But without adequate procedures in place to manage both the upside and downside of risk, many of them have been unable to create real sustainable value.

1.2 As a result, many countries are now issuing tighter guidelines on the way in which risk is monitored and publicly reported.

1.3 There is a new appreciation of the wider scope of risks facing businesses, requiring them to look at risk in a more structured way.

1.4 It is clear that risk management is now a core business process and should be planned accordingly and on a continuing basis so as to reduce risk and volatility and improve returns.

2. Our research

2.1 The Institute of Chartered Accountants has been, and continues to be, a major contributor to the debate on managing business risk.

2.2 This briefing summarises recent work by The Faculty of Finance and Management looking at current practice in risk management. The Faculty first published a comprehensive guide, *Business risk management*, in 1996 when the topic was in its infancy. This was one of the first documents to view business risk as a cross-organisational technique rather than a narrow, mainly financial discipline.

2.3 Since that first work, risk management has become established as a core business activity. However there is still little guidance on how companies should best manage risk, who should be responsible and where to turn to for advice. This briefing paper summarises current thinking in this area.

3. Development of risk management

3.1 Whilst the profile of risk management has undoubtedly risen in the last decade, there has been no huge breakthrough or development of a high profile 'must have' management technique. In the 1990s the idea of managing risk throughout the organisation was relatively novel and most companies still focused on specific, mainly financial and insurable risks. The development of risk management has been characterised by a gradual acceptance that a good risk management process is an essential part of being in business.

3.2 The role of the risk manager has developed and has been refined, although it is still relatively new and appointments of board-level risk directors are only just starting to be made.

3.3 Products for managing risk have developed too. Financial and insurance markets are no longer so clearly delineated and products cross into both areas. Insurance is no longer seen as the automatic solution to deal with risk.

3.4 There is more discussion of companies choosing their 'risk appetite' and a greater understanding that companies need to look at their own risk culture. There is a better appreciation that good communication and a learning culture, with openness, lack of blame and analysis of mistakes, is the key to effective risk management.

3.5 Enterprise risk management (ERM) as a term has attracted a lot of coverage. This coverage is welcome as it helps to increase the profile of risk management. However, ERM in itself is not a new technique as the ideas of an integrated risk management across the organisation and of risk management being embedded in the culture are central to all risk management processes.

4. Management of risk

4.1 Enterprises in the same industry, facing similar risks, will often choose different risk management strategies.

4.2 Any company needs to ensure that it has a proper continuous risk management process. Each company will organise differently, but the process will generally involve the following steps:

- identifying and ranking the risks inherent in the company's strategy (including its overall goals and appetite for risk);
- selecting the appropriate risk management approaches and transferring or avoiding those risks that the business is not competent or willing to manage;
- implementing controls to manage the remaining risks;
- monitoring the effectiveness of risk management approaches and controls; and
- learning from experience and making improvements.

5. Establishing overall goals and appetite for risk

5.1 Many companies are now aware of their overall goals and they usually have a formal or informal process for both recording them and (most importantly) for communicating them to shareholders and other stakeholders (in this context, 'stakeholder' includes anyone with an interest in the company).

5.2 What is not so common is the formal identification of the company's appetite for risk. There are no standard benchmarks for identifying what level of risk a company chooses to take. In certain sectors a company needs to accept a certain level of risk or it could not operate in that environment. In other situations a company may choose to take a high level of risk as part of a deliberate strategy. Companies should be aware of the relative risks of others in the same sector and highlight any differences.

6. The risk management process

6.1 Major companies, together with academics and professional consultants, have produced risk control systems which, although varying in shape and detail between different industries, generally involve grouping and assessing risks under the following headings:

- strategic;
- operational;
- financial;
- compliance (including health and safety); and
- environmental.

6.2 Strategic risks arise from being in a particular industry and geographical area.

6.3 Operational risks arise from the various operational and administrative procedures that the business uses to implement its strategy.

6.4 Financial risks arise from the financial structure of the business, from transactions with third parties and from the financial systems in place.

6.5 Compliance risks derive from the necessity to ensure compliance with laws, regulations and other less formal societal expectations which, if infringed, can damage a company. Health and safety risks are sometimes straightforward and can be considered as a subset of compliance or operational risk, but in many industries (eg transport) health and safety are key areas which require major resources and concentration.

6.6 Environmental risks can be relatively routine and covered under compliance but in many businesses (and in an increasingly large number) they are a major area requiring separate consideration.

7. Identifying and ranking the risks

7.1 The first and most important step is to identify the risks. This is usually done internally by management through self-assessment exercises, although, in larger companies, consultants are often brought in to assist.

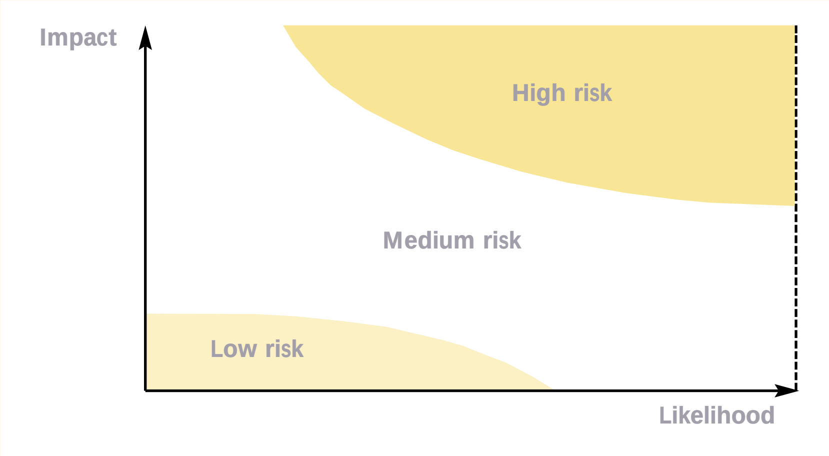
7.2 The risks must then be evaluated in terms of their likelihood of occurrence and their severity if they do occur. There are a number of ways of doing this, including ‘risk mapping’, which plots the likelihood of the risk occurring on one axis and the severity or impact of the risk on the other.

7.3 Impact can be measured in many ways – ultimately there will be a financial effect but as this is often extremely difficult to calculate with any certainty, businesses often use a series of levels (measuring the overall effect on the business or selected business unit in a larger organisation). Whatever method is chosen it must be clear and easily understood by everyone in the organisation.

7.4 Measuring likelihood is a similar exercise. Usually a series of categories is chosen, for example linking each one to a frequency such as every day, every month, or every 10 years.

7.5 Once each risk is plotted, the chart can be divided into categories of risk, usually high (top right corner), medium and low (bottom left corner). The concentration should then be on reducing the higher risk items lying in the top right corner of the chart.

Measuring the impact and likelihood of risk



8. Defining appropriate actions for managing these risks

8.1 Appropriate responses must then be prepared to all the risks that would significantly affect the strategy or returns of the company if they were to occur.

8.2 Various methods are used to deal with risks ranging from avoidance and diversification through monitoring with appropriate corrective action to hedging and insurance. Complete elimination of a risk or reduction to an acceptable level may not always be possible and sometimes the risks may be so high in a particular business or process that it is not sensible to proceed. In other businesses there may be risks (eg volatility or economic or weather) that are inherent to the business but which, so long as they are explained, investors are willing to accept if the likely return is also commensurately high. Investors, can, of course, reduce their own risks through diversification.

8.3 Generally the four main ways of dealing with risks are grouped as follows:

- accept;
- transfer (usually via insurance);
- reduce/manage; and
- eliminate.

These are sometimes referred to as the four Ts (tolerate, transfer, treat or terminate).

9. Taking action

9.1 Having evaluated and agreed appropriate actions and procedures to reduce the risks, these measures then need to be put in place. It is also necessary to introduce reporting and monitoring mechanisms so that senior management, directors and eventually shareholders can see that the risks are being properly considered and addressed both initially and on a continuing basis. It is important not to rely solely or even mainly on self-assessment and to include effective third party monitoring – normally through internal and/or external auditors.

9.2 Risk management is not a one-off exercise. Risks need to be monitored on a regular basis – the business environment changes rapidly, as do the ways of managing risks. It is particularly important to be alert to new risks that a business may face and to have early warning systems in place to monitor for changing risk levels.

10. Who should manage risk?

10.1 In small organisations, the finance director or chief executive tends to add the role of risk management to his/her other responsibilities. In larger organisations this role is likely to be undertaken by a risk management committee, led by senior executives, or board directors. The increasing prominence of risk has resulted in the new role of a board-level chief risk officer being created in some companies.

10.2 Although the finance director should undoubtedly be involved in most aspects of risk management, it is not ideal that he/she is solely responsible for risk throughout the company.

10.3 Following the Turnbull report, risk related self-assessment workshops were often led by internal audit staff. As the process has developed and with the greater general understanding that risk is a company-wide responsibility, much of the leadership has been passed on to the line management.

10.4 There is a greater understanding that risk management must be led from the top of the company and needs to involve all employees in some capacity to be truly effective.

11. The risk management process – an overview

11.1 The key requirements of the process are to:

- identify responsibility and reporting lines for risk;
- determine your risk appetite;
- list risks within the five suggested categories (strategic, operational, financial, compliance, environmental);
- rank risks by, for example, using a matrix diagram;
- define appropriate action for risks according to the four Ts;
- take action;
- monitor regularly through better risk reporting;
- learn the lessons and feed back into the process.

12. Conclusions

12.1 Although managing risk has always been considered important, it has generally been managed as a separate function. It is now important to have a company-wide, integrated procedure in place to monitor and control risks.

12.2 It is important to bear in mind that the overriding objectives are to reduce the downside risks and minimise lost opportunities from risks facing the business and not simply to come up with processes that appear to do so in order to comply with corporate governance requirements. Good, genuine risk management processes will comply with requirements but, more importantly, will also be improving the quality and returns of the business.

Where next?

The Institute has set up a web site collecting together all its resources on risk management and risk reporting and providing links to further information on the topics contained in this document – www.icaew.co.uk/risk.

FACULTY PUBLICATIONS AND SERVICES

Keeping you at the leading edge of finance and management

Finance & Management

A monthly newsletter containing a range of articles and analysis of current topics, as well as Faculty news and events.

Management Quarterly

Published in association with Cranfield School of Management, this provides a concise summary of much of the basics covered in an MBA including: 'Strategy', 'Human resources management', 'Marketing' and 'Finance'.

Manager Update

A quarterly publication providing a high-level look at the latest management developments and concepts. Published in association with Henley Management College.

Good Practice Guideline

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Recent subjects include 'Beyond budgeting', 'ValueReporting' and 'Strategic enterprise management'.

Web site

There is a wide range of information on the Faculty's web pages – exclusive to members.

Audio and video tapes

Tapes of Faculty lectures are available to all who cannot attend.

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Risk management and reporting

This paper is a contribution to the continuing programme by the Institute to develop ideas and publish guidance that will improve company risk management and reporting.

Recent publications include:

- *Business risk management* (1996)
- *Financial reporting of risk – proposals for a statement of business risk* (1997)
- *No surprises – the case for better risk reporting* (1999)
- *Internal control: Guidance for directors on the Combined Code* (1999)
- *Implementing Turnbull – a boardroom briefing* (1999)
- *No surprises: working for better risk reporting* (2002)

Copies are available as downloadable pdfs from www.icaew.co.uk/risk.

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