# The reality of risk

Running a risk register is a thankless task and is not the best solution to addressing risk. In reality, says **Matthew Leitch**, the integrated accountant's role is more likely to help manage uncertainty and may already be creating a revolution

Where accountants support decision-making, should they focus on detailing the best estimate, or provide an understanding of the alternative possible outcomes and their likelihood?

What do you think? It's most likely that you think accountants should provide understanding of the alternative outcomes, which shows you understand the essence of risk management. To understand why this has become vitally important to accountants and risk management, we need to go back in history to understand how risk management has developed, why there's a crisis now, and why the everyday work of accountants may hold the key to a remarkable improvement.

## THE ORIGINS OF RISK MANAGEMENT

Perhaps the best place to start is with the first formal work on probabilities, some 350 years ago, by Pierre de Fermat and Blaise Pascal who, in 1654, laid the groundwork for probability theory. Since then, huge strides in understanding uncertainty have been made, especially in the 20th century, and progress still continues. Developments in management science, in particular, have provided techniques to deal with uncertainty in most management activities.

This scientific approach has been, and continues to be, the main thrust of risk management across most disciplines and countries. It informs regulations on banking, insurance, nuclear safety, health, disease control, and many other areas of our lives.

However, in the early 1990s an approach based on making lists of 'risks' came to prominence largely thanks to groups like the Committee of Sponsoring Organizations of the Treadway Commission, and the Australian and New Zealand Standards bodies. In the UK the list of risks is usually referred to as a "risk register".

This risk-listing approach has been promoted heavily by regulators and dominates thinking on risk management in internal audit, corporate governance, project management, and low-end health and safety. The risk register has come to define risk management for many people. Most accountants involved with risk management at work will have come across risk registers and the risk-listing approach.

## THE INTEGRATION CRISIS

Despite two decades of promotion, risk-listing remains unloved and often ineffective. Risk registers sit on the shelf gathering dust, compiled and retrieved for audit committee meetings and little else.

The reason lies in the idea of making a list of risks and then managing them. Although almost everyone agrees that risk management should be part of core management activities – a by-product of good management – the reality is that risk-listing remains a separate activity with its own meetings, documents, reports, schedule, experts, and jargon.

Risk-listing faces a crisis because it cannot deliver the integration into management activities that people prefer and want. The act of creating 'risks' and managing them, inevitably, makes this approach something that stands outside normal business planning and decision-making.

## THE ROLE OF ACCOUNTANTS

But, while risk-listing has been struggling, accountants have been getting on with a different, more integrated form of risk management. They've been helping colleagues deal with risk in decision-making, planning, monitoring, and other core activities through techniques such as key performance indicators geared towards risk assessment, probabilistic forecasts, analysis of uncertainties, 'what-if' forecasting and many others.

The importance of this can be understood by considering the number of accountants and their roles. There are far more specialist accountants than there are specialist risk managers. Almost every company uses or employs an accountant, but few have a specialist risk manager. ICAEW had more than 138,000 members at the end of 2011, while the two leading organisations for risk managers in the UK, the Institute of Risk Management (IRM) and the Association of Insurance and Risk Managers in Industry and Commerce (AIRMIC), had fewer than 5,000 members between them.

> Accountants are already routinely and deeply involved in decision-making, while specialist risk managers often find themselves battling for influence

Accountants are already routinely and deeply involved in decision-making in the organisations where they work, while specialist risk managers often find themselves battling for influence.


ELLY WALTON/IKON

## GROUNDBREAKING SURVEY RESULTS

At the end of 2011, I carried out a survey with the Association of Chartered Certified Accountants (ACCA) asking its members about the behaviours they saw at work, and the practices their organisations' accountants used for risk management.

There were no questions about risk registers, risk reports, risk appetite, risk roles – no real 'risk' questions at all. Respondents, however, immediately recognized their role in risk management through their day-to-day activities and practices.

## SUPPORT FOR RISK-MANAGING PRACTICES

The full report of results contains more detail than it is possible to repeat here, but the main finding across the 39 practices polled was that they received a strong level of support. Most respondents said they were already using the practices and would continue to use them, use them more, or would start using them. Even the practices involving Monte Carlo simulation – a random sampling technique which assumes that uncertainties form a pattern and which is easily done in a spreadsheet – received majority support once you exclude those who did not know what the simulation was.

The full list of practices included in the survey provides a guide, but not a comprehensive one, to what constitutes integrated management of risk:

- core management activities:
- management accounts;
- regular financial forecasting;
- other decision support;
- reporting process quality; and
- financial compliance and ethics.

They included items such as:

- reporting liquidity statistics;
- analysing past trends, including variability;
- examining the proportion of fixed costs;
- analysing the sensitivity of results to factors such as exchange rates;
- risk-adjusted performance measures;
- documenting assumptions; and
- forecasting for alternative scenarios.

These practices are not new, but what is new is recognising them as risk management.

The enthusiasm for these practices is consistent with other survey findings. A massive 92% of respondents thought accountants providing decision support should focus on the understanding of alternative outcomes rather than detailing the best estimate. This overwhelming view was common across different countries, roles, sectors, degrees of experience, and between men and women.

Respondents also strongly supported a culture of ethical behaviour, objectivity, and recognition of uncertainty, but not baseless conviction and macho management.

## REPORTS OF DYSFUNCTIONAL BEHAVIOUR

Some other findings concerned behaviours that undermine good management of risk. These included behaviours such as:

- understating costs and overstating benefits to get approval for a proposed course of action;
- treating forecasts as targets rather than predictions;
- giving optimistic forecasts to avoid criticism, and pessimistic predictions to manage expectations;
- decision making that was strongly biased by personal interests or derailed by personal power battles; and
- stating expected results from a course of action with unjustified confidence, purely to make it more attractive.

Across the 14 behaviours, on average, most respondents reported that the behaviour occurred in their organisation at least sometimes, usually, or always. Of 1,127 respondents who answered all 14 questions, only eight reported that none of the behaviours ever happened. This prevalence of dysfunctional behaviour was only weakly related to pressure and organisation size. It seems that even small companies suffer from what we think of as big company politics.

These behaviours are not mild issues that people understand and make allowances for. Some were precisely the ones that respondents thought had led to failed strategies and contributed to the credit crunch. One of the questions asked respondents to choose three causes of company strategy failure in the past three

| CAUSE OF FAILURE | DYSFUNCTIONAL BEHAVIOUR | NEVER | SOME-TIMES | USUALLY | ALWAYS | DON'T KNOW |
|---|---|---|---|---|---|---|
| "They underestimated risks" | Assessing 'risk' as low to make a course of action more attractive | 26% | 46% | 13% | 4% | 12% |
| "They overestimated their ability to predict and control future events" | Stating expected results from a course of action with unjustified confidence to make it more attractive | 23% | 46% | 15% | 4% | 12% |
| "Their decisions were biased by personal interests" | Significant decisions strongly biased by the personal interests of decision makers | 16% | 47% | 21% | 8% | 9% |

years and the top results were:

- "they underestimated risks"
- "they overestimated their ability to predict and control future events"
- "their decisions were biased by personal interests"

Behaviours similar to these were included in the survey and their reported prevalence is shown in the box (right).

## REDUCING DYSFUNCTIONAL BEHAVIOURS

Good practices and bad behaviour were demonstrably linked. The more respondents reported that good practices were used, the less they reported bad behaviour. And the worse the behaviour they reported, the more respondents wanted to extend their use of good practices. Clearly, respondents thought that good practices could help reduce bad behaviour and its effects.

This link was found by analysing data across all practices, and also by asking specific questions about the impact of accountants on decision-making. Respondents reported that the impact of accountants on behaviour around decisions was more positive when they also reported that many of the good-decision-support practices were in use. It should be remembered that all of these items concern management under uncertainty/risk.

## IMPLICATIONS FOR REGULATION

Regulators interested in encouraging good governance have a number of options. One is to continue to press companies and other organisations to work more with risk registers and assurance processes. Perhaps by updating them more frequently, adding further details, or setting clearer policies about risk levels for identified risks already on the register. With extra effort, perhaps the risk-listing ritual might start to add value.

Another approach is to encourage companies – and their accountants in particular – to pursue more of the good practices that they may already be doing – at least partially. These are simply the familiar practices that help boards and managers deal with risk within core activities.

> Although registers have had a lot of attention and have been seen as 'risk management', the reality lies in the assessment of how managers behave

## ACCOUNTANTS' OPPORTUNITIES

For most accountants there is already a clear direction: enacting more of the good practices that help their colleagues deal with risk. What practices those are in each case will probably differ and it is vital, of course, to provide the support that people want.

But despite its scope, the survey did not probe the behaviours and preferences of board members and executives who were not accountants. How do they grapple with their jobs in the face of risk? What extra support would they most value?

Recent research by Terry McNulty, Chris Florackis, and Phillip Ormrod – all of them from the University of Liverpool's Management School – contains fascinating extracts from interviews with board members that reveal the reality of risk management at that management level. Once again, risk registers are not the focus of the research. Instead, it is all about everyday behaviours that manage risk.

Their extracts show that members are:

- interested in the risk implications of financing, for example, debating the impact on their gearing;
- examining the possible results of acquisitions, considering the implications of various types of failure;
- renegotiating the price of an acquisition and adjusting the ratio of debt and equity to reflect a higher estimate of the probability of failure;
- using an iterative approach to difficult decisions in which initial information is used to decide whether to investigate further, leading step by step to more formal analysis and, ultimately, to investments; and
- more in favour of investments that pay back sooner.

This is surely just the tip of the iceberg. Look at the conversations people have when tackling business planning and decision-making, and you will see many examples of people responding to their uncertainty (ie, managing risk) in familiar, natural ways.

Although risk registers have had a lot of attention and have been seen as 'risk management' by many in the governance and risk management world, the reality of true risk management lies in the assessment of how managers behave. It does not lie in a separate process with equally separate documents and meetings. Accountants have a key role in risk management and their supportive practices – which are typically objective and auditable – are a promising direction for any regulator or board interested in improving risk management. They should be encouraged.

### FURTHER READING

Leitch, M, (2011). *The reality of risk: culture, behaviour, and the role of accountants*. Published by ACCA. Available online at: **bit.ly/UnX5Ps**

McNulty, T; Florackis, C; and Ormrod, P (2012). *Corporate Governance and Risk: A Study of Board Structure and Process*. Published by ACCA.

**Matthew Leitch** is a chartered accountant, author, researcher, and consultant specialising in how to work more effectively in uncertain conditions. He is a member of the risk management committee of the British Standards Institution and lectures at the University of Southampton's Management School.