LET'S PLAY RISK....

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Objective:

The objective of this article is to understand the phenomenon of Risk & its impact in other words "Dealing with Risk" in order to get reasonable assurance to achieve the desired Vision Mission Strategic Objectives and Goals of an organization.

Background:

Risk is used to describe as final outcome may differ from what was expected at the time when the decision was taken, risk and uncertainty plays vital role must be taken into account in strategic planning sometimes these both are to be used interchangeably but there is difference between these too, risk can be quantified based on probabilities and uncertainty can not. Every industry/sector is subject to risk varies from industry to industry being inherent factor "Risk can never be eliminated but can also be minimized". An organization might be facing of different risks but most important need to carefully deal with are Strategic and Operational risk, might result in serious threat/impact to an organization as a whole. Strategic risk arises due to strategic decisions taken in light of external environment by directors for persuading to goals and objectives. Strategic example is in early 1980s IBM reported the largest corporate loss; IBM did not predict the revolutionary effect that PCs would have on manufacturing and consumers. IBM changed from being predominantly

a hardware manufacturer to consultancy services, and sold its laptop business to Lenovo a china based company. Operational risk arises due to day to day operations in light of internal environment, operational risk example is "Banks urged to adopt strong risk management culture", There is a pressing need for banks to modify their fragmented approach of operational risk management in favour of a much more comprehensive governance and risk management framework through clearly defined roles and responsibilities along with reporting procedures, The State Bank of Pakistan (SBP) Governor dwelt at length on three main areas, including operational risk management - the issues and challenges; treatment of operational risk and emergence of sound principles risk management and regulatory developments and supervisory expectations to strengthen the operational risk management within the banking sector.

Risk Management

RISK AVERSION:

Risk aversion depends upon the management psychology and behavior, for example management might choose to invest into a bank account with a low but guaranteed interest rate rather than into a stock that may have high expected returns which also involves a chance of losing value. However management may have different types of attitudes towards risks as follows:

a) A risk seeker is a decision who is interested in the best outcome irrespective of small chance of occurrence. The perception always alien with the philosophy of high risk-high return and reward.

b) A risk neutral is a decision maker who is interested in most likely outcome having the greater chance of occurrence.

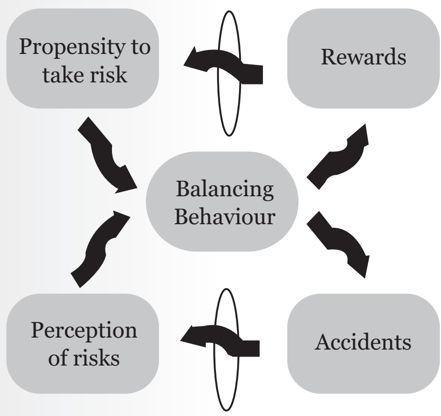
c) A risk averse is a decision maker who already assumes the worst possible outcome even if there is remote chance of occurrence.

Risk Thermostat Model (John Adam)

John Adams is a Professor of Geography at University College in London specializing in risk management; Risk management is a balancing act. It involves balancing risks and rewards. The risk thermostat is a simplified model postulates that everyone has a tendency to take risks - the setting of the thermostat, some like it hot, others cool, but no one wants absolute zero.

Strategic Risk	Operational Risk	Commercial Risk
Financial Risk	Audit Risk	Currency Risk
Interest rate Risk	Market Risk	Credit control Risk
Financial record Risk	Financial reporting Risk	Finance provider's Risk
Credit Risk	Liquidity Risk	Legal Risk
Political Risk	Technology Risk	Data security Risk
Internet Risk	Fraud Risk	Health & safety Risk
Environmental Risk	Probity Risk	Knowledge management Risk
Property Risk	Trading Risk	Human error Risk
Disruption Risk	Production Risk	Organizational Risk
Reputation Risk	Industry specific Risk	Insurance Risk
Economic Risk	Inflation Risk	Natural Disasters Risk

The tendency is influenced by the potential rewards of risk taking perception's of risk are influenced by experience of accident losses - one's own and others' risk taking decisions represent a balancing act in which perceptions of risk are weighed against propensity to take risk accident losses.



Risk Assessment Process: (Eight Components)

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) is a joint initiative of five private sector organizations, established in the United States and is dedicated to providing thought leadership through the development of frameworks and guidance on enterprise risk management, internal control and fraud deterrence.

The COSO framework defines internal control as a process, affected by an entity's board of directors, management and other personnel, designed to provide "reasonable assurance" regarding the achievement of objectives as effectiveness and efficiency of operations, reliability of financial reporting and compliance with applicable laws and regulations.

The risk management framework is still geared to achieving an entity's objectives; however, the framework now includes four categories:

i. Strategic: Long term goals, aligned with and supporting its mission.

ii. Operations: effective and efficient use of its resources.

iii. Reporting: reliability of reporting.

iv. Compliance: compliance with applicable laws and regulations.

1. Internal Environment - The internal environment of an organization sets the basis for how risk is viewed and addressed by an entity's people, including risk management philosophy and risk appetite, integrity and ethical values, and the environment in which they operate.
2. Objective Setting - Enterprise risk management ensures that management has in place a process to set objectives and that the chosen objectives support and align with the entity's mission and are consistent with its risk appetite.
3. Event Identification - Internal and external events affecting achievement

of an entity's objectives must be identified, distinguishing between risks and opportunities. Opportunities are channeled back to management's strategy or objective-setting processes.

4. Risk Assessment - Risks are analyzed, considering likelihood and impact, as a basis for determining how they should be managed. Risks are assessed on an inherent and a residual basis.

5. Risk Response - Management selects risk responses - avoiding, accepting, reducing, or sharing risk - developing a set of actions to align risks with the entity's risk tolerances and risk appetite.

6. Control Activities - Internal Controls, Policies and procedures are established and implemented to help ensure the risk responses are effectively carried out.

7. Information and Communication - Relevant information is identified, captured, and communicated in a form and timeframe that enable people to carry out their responsibilities. Effective communication also occurs in a broader sense, flowing down, across, and up the entity.

8 Monitoring - The entirety of enterprise risk management is monitored and modifications made as necessary. Monitoring is accomplished through ongoing management activities, separate evaluations, or both.

Risk assessment involves identifying, analyzing, profiling, quantifying and consolidating risk, risk appetite refers to strength and level of risk an organization can bear varies from organization to organization. The Ernst & Young report managing risk across enterprise emphasis that risk assessment should into a consistent, embedded activity rather than be carried out as a significant stand alone process. In 2005 British Petroleum (BP) launched a code of conduct regarding what BP has expectations and wants to ensure that all employees will comply with legal requirements, company standards, safety, workplace behaviour, bribery, corruption and financial integrity.

There is a saying by John Paul Jones “It seems to be law of nature, inflexible and inexorable, that those who will not risk cannot win”. By virtue of nature risk can be controllable and beyond the control of an organization (Uncontrollable) example of uncontrollable risk is the plan developed by the National Disaster Management Authority (NDMA) in collaboration with the Japan International Co-operation Agency (JICA), NDMA commission has approved a “Disaster Risk Reduction Policy” to create capacity for early warning system and for identifying and monitoring vulnerability and hazard trend.

“To know about all possible risks and understanding potential impact is an art”

Control Limitations:

Internal control, no matter how well designed and operated, can provide only reasonable assurance to management and the board of directors regarding achievement of an entity's objectives. The likelihood of achievement is affected by limitations inherent in all internal control systems. These include the realities that human judgment in decision-making can be faulty, and that breakdowns can occur because of such human failures as simple error or mistake. Additionally, controls can be circumvented by the collusion of two or more people, and management has the ability to override the internal control system. Another limiting factor is the need to consider controls' relative costs and benefits.

RISK MITIGATING STRATEGIES:

Once risks have been identified and assessed, all techniques to manage the risk fall into one or more of these four major categories. First Avoidance (eliminate, withdraw from or not become involved), second Reduction (optimize - mitigate), third Sharing (transfer - outsource or insure) and finally Retention (accept and budget). Ideal use of these strategies may not be possible. Some of them may involve trade-offs that are not acceptable to the organization or person making the risk management decisions.

Responsibility....?

The Executive Management, Risk management committee, Internal auditor, External auditor, Managers and staff but it won't be wrong to say that everyone working in the organization is responsible, However Board has the overall responsibility of risk management as being part of the Corporate Governance responsibilities.

“You can measure opportunity with the same yardstick that measure the risk involved. They go to gather”

Effective communication also must occur in a broader sense, flowing down, across and up the organization. All personnel must receive a clear message from top management that control responsibilities must be taken seriously. They must understand their own role in the internal control system, as well as how individual activities relate to the work of others. They must have a means of communicating significant information upstream. There also needs to be effective communication with external parties, such as customers, suppliers, regulators and shareholders. This is accomplished through ongoing monitoring activities, separate evaluations or a combination of the two. Ongoing monitoring occurs in the course of operations. It includes regular management and supervisory activities, and other actions personnel take in performing their duties. The scope and frequency of separate evaluations will depend primarily on an assessment of risks and the effectiveness of ongoing monitoring procedures. Internal control deficiencies should be reported upstream, with serious matters reported to top management and the board.