

Company Risk Assessments

Using the Right Tool for the Right Job



All of us have an appreciation for knowledge and skill. If you have ever watched an artist work with clay to make pottery or a carpenter shape wood, it is hard not be impressed with the knowledge and skill they display when working. To be successful they not only have to understand the materials, but they also must use the right tools and methods to get the job done properly.

Their tools are among the most precious things the artisan or the tradesman owns for even the most skilled amongst them cannot perform his job properly without using the right tool for the right job.

As 2009 draws to a close many businesspeople have expressed relief that such a tumultuous year has finally drawn to a close. There is probably no year in recent memory where so many events

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have occurred that so many did not foresee.

There has been a lot of talk in the media and in boardrooms about governance failures.

Many of these discussions tend to focus on specific items such as accounting standards, director independence and portfolio concentration. To be sure, these are all important topics; however, they are symptoms of the disease and not the disease itself.

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The primary driver leading to corporate governance failures is the lack of a rigorous and complete risk assessment process.

While it is true that almost every company performs a risk assessment, the tools available to those performing the risk assessment are limited and they are not used to their full potential.

What we will discuss in this article are various types of risk assessment tools that can be used along with strategies for maximizing the effectiveness of each of them.

What is risk, why assess it and who should do it?

In a company setting risks, can be defined simply as threats to profitability. Anything that can reduce the profits of the company is a risk. This can be something as direct as buying inventory at too high of a price or as indirect as damage to the company’s

reputation.

Companies need to assess risk for the simple reason that we cannot mitigate risks if we don’t know they exist. Only by specifically identifying risks and then prioritizing them can a company decide how to best spend its resources in preventing them from occurring.

In most companies the internal audit function performs an annual risk assessment for the company. This risk assessment is used by Senior Management, the Board of Directors and Internal Audit to set the priority for audits to be performed in the coming year. Other functions such as Compliance, Legal or the CFO’s office may also perform the risk assessment.

What tools are available to assess risks?

As in the example of the artist, for a company to produce a quality risk assessment the right tools and methods must be used.

There are many tools available when performing a risk assessment and some are more effective than others. Below is a discussion of the most commonly used tools along with the advantages and disadvantages of each. We list the tools in order of effectiveness from least effective to most effective.

Rotation

The simplest form of risk assessment is to take the view that all areas of the company present the same amount of risk and therefore should be allocated the same amount of resources for mitigation. In truth this is not a true risk assessment, as each area within the company is not evaluated separately but rather assigned a risk level as a whole.

This method is best used when the company has homogenous business units and operates in one country.

The drawback to this method is that even if a company’s operations are fairly simple, there are always different risk levels in various areas of the company. This is natural as there are differences in local management, processes, and localized IT systems.

Industry Lists

Various organizations have performed studies and identified risks associated with specific industries. These “listing of risks” can be purchased and used by companies to allocate their risk mitigation resources.

These lists tend to be well researched and contain information from a broad cross section of companies within a particular industry.

The weakness of these lists is that



they are general and may not take in account the specific business model or history of your company. Companies that desire to utilize these lists would do well to attempt to customize them to the extent possible in order to extract the maximum benefit.

Interviews

Conducting interviews with Senior and Operating Management and the Board of Directors can be an effective method of risk assessment. These constituencies are very familiar with the corporate history, future business plans and current operating issues of the company.

The challenge here is avoiding the

biases of the person conducting the interviews and the person being interviewed. We may be able to identify the risks within the company; however there is a possibility that the risks may be under or over stated by the person being interviewed or over or under reported by the person conducting the interview.

Another logistical challenge to this method is compiling and interpreting the information gathered. For example, what if two people that were interviewed contradict one another? Whose point of view will prevail? What if the interviews were performed by many different individuals? How can we document the results of

all the interviews in a central location

When using interviews to perform a risk assessment care must be taken to devise a system of documenting, evaluating and compiling the results of the interviews.

Excel Modeling

A more automated and sophisticated tool for risk assessment is Excel. An Excel model can systematically document each area of the company being and use simple mathematical formulas to calculate a risk score for each area. The formula is based on risk factors assigned by the company.

Excel is best used for companies with many operating units or functions. Significant amounts of data can be gathered and processed and the results of interviews can be incorporated into the Excel model.

This is the most effective method we have discussed so far. Excel offers an experienced risk professional the ability to consolidate data from many sources and systematically compare and contrast the risk score for each risk area under consideration.

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For example, Excel processes data in a linear fashion. This means it can only evaluate each risk area separately, and it has no ability to process more than one risk at a time. Excel also cannot identify patterns of risk that have been particularly dangerous for the company in the past.

Neural Network Modeling

Some advanced companies are beginning to use neural network modeling to identify and reduce their risks. Neural network models have the ability to systemically document each area of risk and also have the ability to form inter-relationships between risk areas and identify risk patterns that demand the attention of Senior Management and the Board of Directors.

Neural networks are best employed in situations where companies have an advanced view of risk and a desire to formulate



a comprehensive insight into the risks faced by the organization.

For an example of how neural network models operate, let's take the following example.

A company identifies four risk areas for evaluation and using an Excel model calculates a risk score for each area as follows:

Excel looks at each of these four risk areas separately and has assessed each one as either low or medium risk. If the company stopped their risk assessment here they would be missing an important point.

A company using a Neural Networks model would further recognize that a company division

operating in Brazil, that is selling gold, dealing in cash, and using a complex system of accounting presents a very high risk to the company.

The drawbacks to neural networks are their complexity and the data demands of the model itself.

Conclusion:

Risk assessment is a key activity that should be done by the company once per year at a minimum. Companies cannot engage in effective mitigation of their risks until they can properly identify and quantify them.

Spending the time, money and effort to assess risks will pay for itself by avoiding the misallocation of resources toward activities

that do not result in a significant reduction of risk to the company. There are many methods and tools available to companies for risk assessment. The key judgment to be made is how the tool or method is going to be used and how serious the company is about risk assessment.

Similar to the tradesman and artisans described at the beginning of our discussion, smart companies will select the right tool for the right job.

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