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Strategically Managing the Dynamic Risk Landscape

Updating the risk landscape with new and emerging risks helps in providing interesting inputs to strategic management, e.g. recognizing potential stumbling blocks for strategic initiatives, while also keeping the audit scope relevant and forward-looking. Highlighting the risk clusters in the risk landscape helps the Audit Committee to allocate resources in the audit plan and other risk management measures to the areas where their impact is the greatest, as well as identify new strategic prospects. Measuring the speed with which individual risks manifest themselves sets the timeframe for reacting to the occurrence of a risk event, as well as the timeline for measures to mitigate the risks.

The risk landscapes within which companies operate today are increasingly complex and dynamic. Three challenges in making sure the company's evaluation of the risk landscape reflects the state of the business currently and in the foreseeable future are matched by the significant benefits of this effort. The three challenges are, first, to identify and incorporate new and emerging risks into the risk landscape; second, to assess and take account of the interconnectedness of risks which can form into clusters; and third to measure the duration in time between the occurrence of a risk and its negative impact on operations, in order to design risk management measures accordingly. Interestingly enough, in addressing these issues in dynamic risk management companies can also gain insights which are beneficial to their overall strategic management.

Identifying new and emerging risks to define the scope of risk management measures

In the previous edition of the Audit Committee News it was noted that managing the issues and risks associated with Corporate Social Responsibility is a relatively new field in the business world. Companies lack experience and routine in managing the processes to identify and deal with the risks in this area. Furthermore, the risks in CSR are often specific to an industry or even to a company, where the sources of such risks are spread widely through the organization and beyond into the activities of business partners or potentially other stakeholders. The process to identify CSR risks under such circumstances may require a special effort to dig deep into the operations in the entire supply chain, searching for risks without corporate blinkers or projecting the past into the future. At the same time identifying the CSR risks can help in guiding the company away from potential danger areas, e.g. by establishing a checklist of "no-go" CSR issues which can be used in screening strategic initiatives.

Compliance regulations and the manner in which they are enforced is a field whose contours change often. Thus companies are continually faced with managing compliance in a new and thus unfamiliar environment. Addressing these risk management issues can include an approach analogous to the one outlined above for CSR issues: a deep dive into the specifics of the operations across the entire supply chain in order to identify the new and emerging compliance risks as well as develop tools to steer the company away from danger areas.

Alongside these two kinds of external risks possibly calling for special attention, new and emerging risks can arise within the organization itself. For example, a company with a string of successes in grasping market opportunities may come to the conclusion that it faces heightened risks in overstepping itself when pursuing further opportunities: past successes could breed a sense that the company can do no wrong. The prospects for new ventures may need to be checked carefully to review the possibility of over-estimating future success. A risk identification process which acknowledges the risk dynamic arising from internal developments is helpful in keeping up-to-date with potential sources of internal threats. Furthermore, senior management can be made aware that an entrepreneurial corporate culture focused on successfully pursuing current opportunities could possibly hinder the slow, systematic development of a new business unit with a long-term horizon.

Traditional risk management methodologies often project the past into the future without taking account of the dynamic systematic trends within industries which create new market structures determining success or failure. Identifying new and emerging risks can be beneficial to the company by being able to define the scope of risk management processes to match the sources of risk. The responsibilities and coverage of the risk management function, the internal and external audit, and other risk management mechanisms can be divided up to specifically cover the new and emerging risks. In addition, the company gains insights which can be useful in formulating and implementing strategy.

Risk clusters and differentiated risk management measures

Since the Financial Crisis in 2008/9 it is apparent that risks can form clusters and trigger one another. It has become accepted to treat risks in clusters, e.g. as done by the World Economic Forum. Recognizing that there is risk interconnectedness leads to three sets of risks within the risk landscape. First, there are multiple risks which impact each other and thus form a cluster. Second, there is a set of risks which are the most influential in the risk landscape: they are contagious, like viruses, and if they manifest themselves, they trigger other risks to occur. Third, there is a set of risks which are the most influenced in the landscape: they are vulnerable, like a person weakened during an infection, and can be triggered by numerous other risks. Dynamic risk management needs to deal with these different sets of risks in different ways.

First, an example of risks forming a cluster could be the three sources of risks rooted in a company's business model, in its relations with strategic partners and in its product portfolio. For example, an unsuccessful business model based on building online business could sour relations with disappointed strategic partners as well as weaken the product portfolio which is not able to achieve sales targets. Or, in the other direction, a product portfolio which is not aligned to customer demand could lead to increased pressure on strategic partners to improve sales in the online business which is underperforming. A third possibility is that a poor selection of strategic partners leads to weak contributions from them, undermining both the online business and the product portfolio. And so on. Given the domino effects in the clusters, and their central role in the risk landscape, it can be suggested that company organs charged with corporate governance should pay particularly close attention to the risks in the most prominent clusters. Resources in the internal and external audit plan, in the reporting process, and in other risk management processes should be allocated to risk clusters, rather than simply individual risks. In terms of strategic management, risk clusters point to areas of the business which need to closely collaborate and work together in implementing the strategy.

Second, the manifestation of any one of the contagious, most influential risks can spread like wildfire through the organization, triggering other risks. An example could be the risk of a key product losing market viability. The manifestation of this risk could trigger other risks relating to the company reputation, motivation of personnel, investor satisfaction and the commitment of distributors. On the one hand contagious risks call for preventive risk controls so that they do not occur in the first place. On the other hand, exactly these influential risks can be turned on their head to point to strategic opportunities. For example, the upside potential in the influence of a key product could lead the company to pursue a strategy in which one product is decisively promoted to become central to a market. This one key product could open up many other doors. Another example of treating influential risks is the following. A company may observe that the threat from the competition, both existing and potential rivals, is interconnected with numerous external and internal risks. The response in dynamic risk management could be to strengthen the processes which gather and evaluate competitor intelligence. With regard to strategic management, the danger of a new entrant into the market could be turned into the potential of a strategic alliance with that company.

Third, the most vulnerable risks in the risk landscape are the ones most affected by other risks. A possible example could be employer attractiveness; a company could realize that the occurrence of almost any risk could negatively impact the willingness of personnel to work for the company. Acknowledging that such vulnerable risks can be triggered by many other risks suggests that part of managing them is to include them in the going concern evaluation of risks which could bring down the company. In addition, given that the likelihood of vulnerable risks occurring tends to be higher, another possibility in managing them is to design recovery controls which ensure the return of the company to the status quo before the risk manifested itself.

Conventional risk management methodologies typically focus on single risk events without considering the interconnectedness of risks. By taking account of the latter, risk management measures can be differentiated to address the different nature of the clustered risks. Furthermore, recognizing the clustering of risks can lead to the identification of upside potential in the interconnectedness of risks which can boost the strategy.

Velocity and the timeframe for risk management measures

Risks manifest themselves in a wide range of time frames. Some risks can have an impact on operations within hours, e.g. cyber security or reputation. The risks which manifest themselves most rapidly are often included in the crisis plan. That way everyone knows exactly what to do should such risks occur, allowing the company to react with the same speed as the impact of the risk. Other risks may be assessed to take up to two years or more to have an effect. For example, in the last edition of Audit Committee News there was a call for an open communication culture, in which different viewpoints can be expressed thoroughly and resolutions found. Some companies may discover that the lack of such an open corporate culture constitutes a risk for them, with the negative impacts taking place after e.g. two years. It may be suggested that the two-year duration before the lack of an open communication culture affects the performance of the company should not be interpreted as a reason to lean back and relax. Rather it is a sign that a long-term risk requires long-term measures to address the threat, and starting with such measures as soon as possible is only to be recommended. In addition to being able to time the risk mitigation measures, knowing the velocity of risks which are related to the strategy implementation helps in establishing the timeline for the implementation of the corresponding initiatives.

Dynamic risk management

Dynamic risk management – identifying new and emerging risks while taking account of risk interconnectedness and velocity - complements existing strategic risk management processes and measures by generating additional perspectives. Building on the points drawn above, taking explicit account of the dynamism and complexity in the risk landscape can generate additional benefits throughout the risk management cycle. The effectiveness and efficiency of risk management processes can be improved; decision inputs into a wide range of organizational development issues such as the business model, investments and corporate culture can be generated; and stakeholder management can be enriched with messages to e.g. customers, personnel and the capital market.

Benjamin Wall
Senior Manager
Dynamic Risk Assessment Specialist