ISSN 1744 - 7038 (online)
ISSN 1744 - 702X (print)

Research Executive Summaries Series

Risk and management accounting: best practice guidelines for enterprise-wide internal control procedures

Vol. 2, No. 11

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A book based on this report will be available to purchase from www.cimapublishing.com

Introduction

This executive summary presents the findings from two research projects on risk management which were funded by grants provided by CIMA. The first grant was for a pilot study comprising four mini-case studies. Our major focus in that study was on how risk impacted upon budgeting. The second grant was for a comprehensive survey and analysis of risk management in organisations and in particular how risk management impacted on both internal controls and on the role of the management accountant. Following the statistical analysis of the survey, interviews were conducted with survey respondents and risk management professionals in order to help us explain our findings. This summary therefore provides the results of these three phases of our research.

- A review of the practitioner and academic literature as it affects governance, risk management and management accounting.
- The four exploratory case studies.
- A comprehensive description of the survey design and results.
- Excerpts from the interview data in relation to the survey results.
- A summary of the research findings
- Implications for best practice.

Risk and risk management

Risk has traditionally been defined in terms of the possibility of danger, loss, injury or other adverse consequences. In accounting and finance risk is considered in terms of decision trees, probability distributions, cost-volume-profit analysis, discounted cash flow, capital assets pricing models and hedging techniques, etc.

Risk management is the process by which organisations methodically address the risks attaching to their activities in pursuit of organisational objectives and across the portfolio of all their activities. Effective risk management involves: risk assessment; risk evaluation; risk treatment; and risk reporting. The focus of good risk management is the identification and treatment of those risks in accordance with the organisation's risk appetite. The enterprise risk management approach is intended to align risk management with business strategy and embed a risk management culture into business operations.

A well known and respected risk management approach has been developed by COSO. The COSO (2004) model of internal control comprises eight components:
1. The internal environment sets the basis for how risk is viewed and the organisational appetite for risk.
2. Organisational objectives must be consistent with risk appetite.
3. Events affecting achievement of objectives must be identified, distinguishing between risks and opportunities.
4. Risk assessment involves the analysis of risks into their likelihood and impact in order to determine how they should be managed.
5. Management then selects risk responses in terms of how risks may be mitigated, transferred or held.
6. Control activities in the form of policies and procedures ensure that risk responses are carried out effectively.

7. Information needs to be captured and communicated as the basis for risk management.
8. The enterprise risk management system should be regularly monitored and evaluated.

(Source: Committee of Sponsoring Organizations of the Treadway Commission (COSO: 2004) Enterprise Risk Management – Integrated Framework.)

Case study findings: process and content of budgeting

The purpose of the exploratory case studies was to understand the relationship between risk and budgeting. This involved consideration of how risk was enacted in budgeting and how managerial perceptions of risk influenced the process and content of budgets. The findings from the four case studies (Collier & Berry, 2002) reveal differences based on the contexts of unique circumstances, histories and technologies of the organizations. The four cases illustrated how the different social constructions of participants in the budgeting process influenced the domains – or alternative lenses – through which the process of budgeting took place and how the content of the budget was determined. The purpose and use of budgets was constructed in social settings such that different functional groups (accountants, sales, operations, etc.) saw budgets in different ways (e.g. as a rational planning device, as a political tool to dominate others, or as a method of enforced cost reduction, etc.).

Four domains of risk were observed, reflecting the different social constructions of participants, financial, operational, political and personal. The process of budgeting in all four cases was characterised as risk considered, in which a top-down budgeting process reflected negotiated targets. By contrast, the content of budget documents was risk excluded, being based on a set of single point estimates, in which all of the significant risks were excluded from the budget itself. The separation of budgeting and risk management has significant consequences for the management of risk as the process of budgeting needs to be considered separately from the content of budget documents.

Objective and subjective risk

Despite the traditional accounting and finance emphasis, many risks are not objectively identifiable and measurable but are subjective and qualitative. For example, the risks of litigation, economic downturns, loss of key employees, natural disasters, and loss of reputation are all subjective judgments. Risk is therefore to a considerable extent socially constructed and responses to risk reflect that social construction.

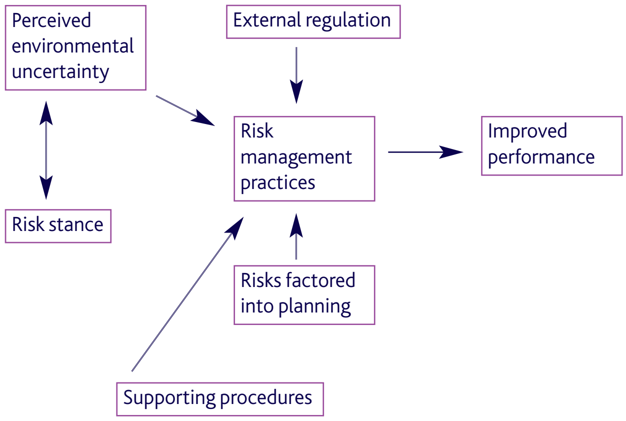
There is an important distinction between objective, measurable risk and subjective, perceived risk. Risk can be thought about by reference to: the existence of internal or external events; information about those events (i.e. their visibility); managerial perception about events and information (i.e. how they are perceived); and how organisations establish tacit/informal or explicit/formal ways of dealing with risk.

Adams (1995) has shown that everyone has a propensity to take risks (from being risk averse to risk seeking), but the propensity to take risks varies from person to person, being influenced by the potential rewards of risk taking and perceptions of risk which are influenced by experience of ‘accidents’. Hence individual risk taking represents a balance between perceptions of risk and the propensity to take risks.

Prior research shows that we know little about how managers consider risks but managers do take risks, based on risk preferences at individual and organisational levels. Some of these risk preferences vary with national cultures while others are individual traits. Individual traits may emphasise risk averse or risk seeking behaviour while some national cultures may also emphasise one or other of these traits. Risk perception is a cultural process, with each culture, each set of shared values and supporting social institutions being biased toward highlighting certain risks and downplaying others. We found that this socially constructed view of risk was a better reflection of organisational risk management than rational modelling approaches typified by text books and professional training as it reflected the subjectivity of risk perceptions and preferences, cultural constraints and individual traits. The four ‘ideal types’ developed by Adams (1995) and adapted in the full report as risk stance: risk sceptical (or fatalists), hierarchists, individualists, and risk aware (or egalitarians), was helpful in our research in understanding individual and organisational risk management practices. The risk sceptical are resigned to their fate and see no point in trying to change it, so managing risks is irrelevant. Hierarchists are always evident in large organisations with strong structures, procedures and systems and are most comfortable with a bureaucratic risk management style using various risk management techniques. Individualists are enterprising, self-made people, relatively free from control by others, to whom risk management is typically intuitive rather than systematic. Risk aware are most comfortable in situations of risk sharing through insurance, hedging or transfer to other organisations. Our survey found that the propensity of managers to take risk and the risk stance (the attitude to risk management in terms of the four ideal types) did influence the risk management practices in use.

Risk management survey

Following the case studies, it was decided to undertake a survey of organisations in the UK to examine risk management practices and the role of management accountants in risk management. The relationships we conjectured during our research design were:



Subsequently, we conducted a survey of CIMA members, finance directors of FTSE listed companies and chief executives of SMEs and analysed 333 usable responses, a response rate of 11%. We subsequently interviewed a number of respondents to aid our interpretation of the survey analysis.

Risk management practices

We found that risk management systems appeared to improve the organisational capacity to process information, both through vertical information systems but also through the role of risk managers. Their role was a cross-functional one, supporting the distinction made between event-uncertainty, commonly viewed as risk, and information-uncertainty (Galbraith, 1977: p.4).

The survey found that the methods for risk management that were in highest use were the more subjective ones (particularly experience), with quantitative methods used least of all. These results suggested a heuristic method of risk management is at work in contrast to the systems-based approach that is associated with risk management in much professional training and in the professional literature. The survey responses implied that traditional methods of managing risk through transfer (insurance, hedging, etc.) were still seen as more effective than more proactive risk management processes.

Risk was seen on an individual level as much about achieving positive consequences as avoiding negative ones. However, organisational risk management was reported to be more about avoiding negative consequences.

In terms of methods of risk management, our interviewees advised us that keeping things simple was best, although more sophisticated techniques were more likely to be used at lower organisational levels. This was largely because business was so complex and supposedly 'objective' methods may not be as reliable as they are sometimes perceived to be.

The trends in risk management were reported to have shifted from being considered tacitly to being considered more formally and the survey results reflected the respondents' expectation that this trend will shift markedly to a more holistic approach with risk management being used to aid decision making. Interviewees provided examples of the beginning of a shift to a more proactive stance towards risk management where this was seen to deliver business benefits. There was a strong emphasis from our interviewees that this shift was likely to increase with a move away from the 'tick box' approach. It was accepted by our interviewees that there was a need to culturally embed risk into organisations as a taken-for-granted practice.

Costs and benefits of risk management

Risk management may be seen largely as a compliance exercise. However, half of the respondents reported that the benefits exceeded the costs, with forty percent reporting that benefits and costs were neutral. Although this was a subjective judgement, the Vice President of a European federation of risk management associations summed up the benefits as:
'An organisation that doesn't issue profit warnings, doesn't have major unjustified exceptional costs on its annual accounts because they thought about things in advance. They have managed acquisitions and mergers proactively to ensure that they have met their targets and objectives and haven't impaired the goodwill or asset values. These are some of the things you might see. A profitable and successful company, excellent reputation, corporate social responsibility – you wouldn't see them being fingered as people who are exploiting the third world, child labour, etc. – all those things sort of come out of it. They have got their supply chain issues sorted out. I guess out in the City analysts are comfortable with what they are hearing and probably their estimates are pretty close to what the organisation achieves. Good credit rating, because they can see that they are good value and their ratios are all good.'

Governance and the drivers of risk management

The Combined Code on Corporate Governance (Financial Reporting Council, 2003) is an important motivator for risk management and internal control practices, requiring Boards to maintain a sound system of internal control to safeguard shareholders' investment and the company's assets. Internal control is the whole system of internal controls, financial and otherwise, established in order to provide reasonable assurance of effective and efficient operation; internal financial control and compliance with laws and regulations. However as profits are, in part, the reward for successful risk-taking in business then the purpose of internal control is to help manage and control risk appropriately rather than to eliminate it.

Given the significant public visibility of corporate governance requirements, our survey findings suggested that risk management may be seen largely as a compliance exercise. Management action to decrease the likelihood of risk was given the highest ranking by respondents, rather than action to achieve organisational objectives. Risk still appears to be dominated by downside concerns and risk transfer through hedging and insurance remains dominant over proactive risk management practices.

Contrary to expectations that risk management practices vary between organisations as a result of their size or industry sector, there was little evidence of any contingent explanations for risk management based on either size or business sector. Similarly, if somewhat surprisingly, respondents' perceptions of the environmental uncertainty and risk facing their organisations did not appear to influence basic risk management practices in those organizations.

The survey results suggested that risk management was driven by an institutional response to calls for improved corporate governance which may reflect both protection and economic opportunity. The external drivers of risk management practices were observed to be external stakeholders and the demands of regulators and legislation, enacted through boards of directors which were likely to exert influence over the policies and methods adopted for risk management.

Financial market risk

In relation to financial market risk, the implication of our regression analysis is that the risk aware stance, in attending to both protection and to opportunity, does create organisations to which the capital markets award a lower beta, and hence a higher value. This led us to infer that the requirements of corporate governance do not necessarily have to work in opposition to economic rationales of risk as opportunity and adventure. However, given the small samples this observation is indicative only and would need to be replicated on a larger scale.

Risk and management accountants

Management accountants, whose professional training included the analysis of information and systems, performance and strategic management, can have a significant role to play in developing and implementing risk management and internal control systems within their organisations (Chartered Institute of Management Accountants, 2002).

The research results have some significant implications for the role of accountants. The responses reveal that line managers were mostly concerned with identifying risk, analysing and reporting on risk. Finance directors had a major role in analysing and assessing, and reporting and monitoring risk. Deciding on risk management action was predominantly the concern of the chief executive and the board. The finance director was identified with more aspects of risk management than any other role, suggesting that they probably have a pivotal role in risk management.

The changing role of management accountants is an important factor in establishing the context for their role in risk management and wider views of management control. Perhaps reinforcing traditional stereotypes, CIMA respondents were more risk-concerned than the other respondent groups in relation to their organisations, despite having a lower perception of the competitive intensity and uncertainty in their industry/sector.

The reliance on formal accounting-based controls was also called into question. Importantly, CIMA respondents were less confident in the formal control systems that existed in their organisations, suggesting that the professional knowledge of accountants accommodates an understanding of the limits of accounting information, a knowledge not shared by non-accountants.

Further, management accountants in the overwhelming majority of organisations were being marginalised in relation to risk management. While CIMA respondents consider that management accountants should have more involvement in risk management, this was not a view shared by other respondents.

Interviewees saw the skill set of management accountants as not being appropriate to a wider involvement in risk management, although their analytic and modelling skills were essential in a supporting role. The distinction between task-oriented management accountants and strategic finance directors was reinforced in our interviews.

Framework for risk management

Our survey results, amplified by our interview data, enabled us to put forward a framework for risk management. This Framework reflects the primary research findings, in particular that:

- There are many external drivers to risk management, not only regulatory but that these are enacted by or through the board of directors.
- Other than organisation size, there appears to be no correlation between environmental uncertainty or competitive factors and risk management practices.
- Risk propensity was not as important as risk stance.
- Risk management practices exist along a continuum of heuristic to systematic but at corporate level the heuristic methods dominate.
- Risk management practices are believed by respondents to move along a life cycle from heuristic to systems dependent to culturally embedded.
- The involvement of accountants in risk management was marginal.
- Risk management was perceived to improve organisational performance and there is indication that a risk aware stance could be related to a lower capital market risk profile.

The framework, in conjunction with that developed by Solomon et al (2000) presents a useful model for understanding how risk management practices are introduced and develop over time.

Best practice implications

Based on our research, our report highlights some fundamental best practice implications for risk management:

- Taking a broader opportunistic approach to risk management, based on a risk/return trade-off, rather than a purely defensive or protective stance.
- Using appropriate and effective tools, but these tools should be supplemented by experience, intuition and judgement.
- A deliberately proactive stance towards risk management, rather than an excessive reliance on traditional techniques, except to the extent that these techniques remain useful.
- Emphasising the importance of culturally-embedding risk awareness in organisations.
- Training users of financial information in the limitations of that information.

There are further best practice implications for CIMA and its members:

- The role of management accountants needs to shift towards a more strategic and value adding role, which by definition includes a consideration of risk, if management accountants are not to be marginalised in risk management processes.
- CIMA members may have to reach Finance Director positions before they can contribute more significantly to risk management, but clearly they should be educated to be able to fulfil that function.

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First published in 2006 by:
The Chartered Institute
of Management Accountants
26 Chapter Street
London SW1P 4NP

Printed in Great Britain

CIMA (The Chartered Institute of Management Accountants) represents members and supports the wider financial management and business community. Its key activities relate to business strategy, information strategy and financial strategy. Its focus is to qualify students, to support both members and employers and to protect the public interest.

May 2006

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