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Value protection and value creation

Turn risk into value

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Audit / Tax / Advisory / Risk

Smart decisions. Lasting value.

Risk management in the Non Profit sector has been around for some time but new thinking is moving towards how to use risk management to add real value.

Successful organisations do this by scrutinising missed opportunities and recognising the need to take risks. They are not risk averse nor do they necessarily have to take greater risks but they have a better understanding of what the risks are and how best to manage them. That means fewer control failures and an increased likelihood of achieving objectives and improved stakeholder value. Supporters and funders may be indifferent about specific risk management models or methods but they will enhance their support for an organisation if it is able to demonstrate it does a better job of managing its risks to create value. Most organisations have some risk management in place but it is often ad hoc and unstructured without a common language. The ones that get it right have the following risk management characteristics in common:

- Practices that encompass the entire organisational structure with clear connections, between the ‘silos’ that often arise within large, mature, and/or diverse organisations and which are only too common in the non profit world.
- Strategies that address the full spectrum of risks, including industry specific, compliance, competitive, environmental, security, privacy, business continuity, strategic, reporting, and operational.
- Processes that augment the conventional emphasis on probability by placing significant weight on vulnerability.
- Approaches that do not solely consider single events, but also take into account risk scenarios and the interaction of multiple risks, this is the concept of risk grouping and a portfolio approach to risk.
- Culture where risk management practices are infused throughout, so that strategy and decision-making evolve out of a risk-informed process, instead of having risk considerations imposed at a later stage.
- A philosophy that focuses not solely on risk avoidance, but also on risk-taking as a means to value creation.

Reward and unrewarded risk

New thinking looks at the concepts of rewarded and unrewarded risks.

Figure 1: Common value creation pitfalls

- Senior management and trustees aren't truly convinced that all employees need to know and understand the organisation's business strategy, value objectives and associated risks
- No common language has been established to help staff use the concept of value to guide their decisions and actions.
- Processes, systems, and people are somehow expected to magically align with the organisation's business strategy.
- An enterprise view of the organisation's project portfolio does not exist – and senior management and trustees aren't convinced that one is needed, even though such a portfolio often represents most or all of a charity's *raison d'étre* and discretionary financial and resource investments.
- Over-commitment to a particular strategy and course of action makes the organisation inflexible, increasing the risk of failure.
- Lack of an integrated performance management system with relevant and usable key performance indicators makes it difficult to react quickly when performance starts to lag.
- Not enough accountability for achieving results. Appropriate and calculated risk-taking is unrewarded, and compensation and rewards are not explicitly linked to performance.
- The organisation does not evaluate and plan for all risk factors when evaluating new ventures.
- Shared risks and dependencies between various objectives are not understood.

Some risks are all downside and no upside. For example, if a non profit organisation fails to comply with local laws and regulations when it works overseas there can be significant consequences, but there's no extra credit for being even more compliant. Similarly, it's important to avoid disruptions to critical operations and systems, but doing so does not earn a premium from stakeholders, it simply meets their expectations. These are the unrewarded risks. They can't be ignored, but the primary incentive for tackling them is value protection.

Other risks are all about upside, for example, introducing new innovations in service delivery or expanding into new areas of income generation. The primary impetus for taking these rewarded risks is value creation. Although they might have a significant downside, the potential upside is even greater.

This distinction between rewarded and unrewarded risks seems simple, but it's amazing how often organisations fail to recognise the difference. In my experience risk management often falls within the remit of the finance director or the internal auditor with oversight from the audit committee or the trustees.

These individuals are usually naturally cautious and therefore in the past many non profits have tended to focus on unrewarded value protection risks.

Value protection risks are important but the risk is that individuals focus the bulk of their attention on the threats and wind up missing out on the opportunities – the focus should shift to value creation. See figures 1 and 2.

Figure 2: Common value protection pitfalls

- The organisation lacks a systematic approach to understand how the organisation could fail and doesn't take steps to prevent such failure – for example, by challenging fundamental operational assumptions to reveal underlying changes.
- Because most of the organisation's traditional risks are being handled by departments, senior management aren't convinced of the need for a more comprehensive and systematic approach to manage risk across the silos.
- Although many risks have been identified, they have not been prioritised through an explicit link to stakeholder value and the organisation's strategy.
- Risk identification and assessment are sporadic, once-a-year activities for certain functions, rather than an ongoing organisation wide effort. Risk management focuses on ice cubes, while overlooking icebergs.
- Risk management is seen as separate and distinct from managing the organisation, and is not embedded in the organisation's day-today processes.

Focusing only on downside can lead to underinvestment in the kinds of opportunities that drive growth and create value for stakeholders. Risk intelligent organisations, on the other hand will understand the distinction between rewarded and unrewarded risks, and they will respond accordingly.

Whether the emphasis is on value creation or value protection, Deloitte research shows that there are a number of common mistakes that organisations continue to make in evaluating and managing risk. And those responsible for risk management should lead the way in addressing the pitfalls.

Linking strategy to risk management

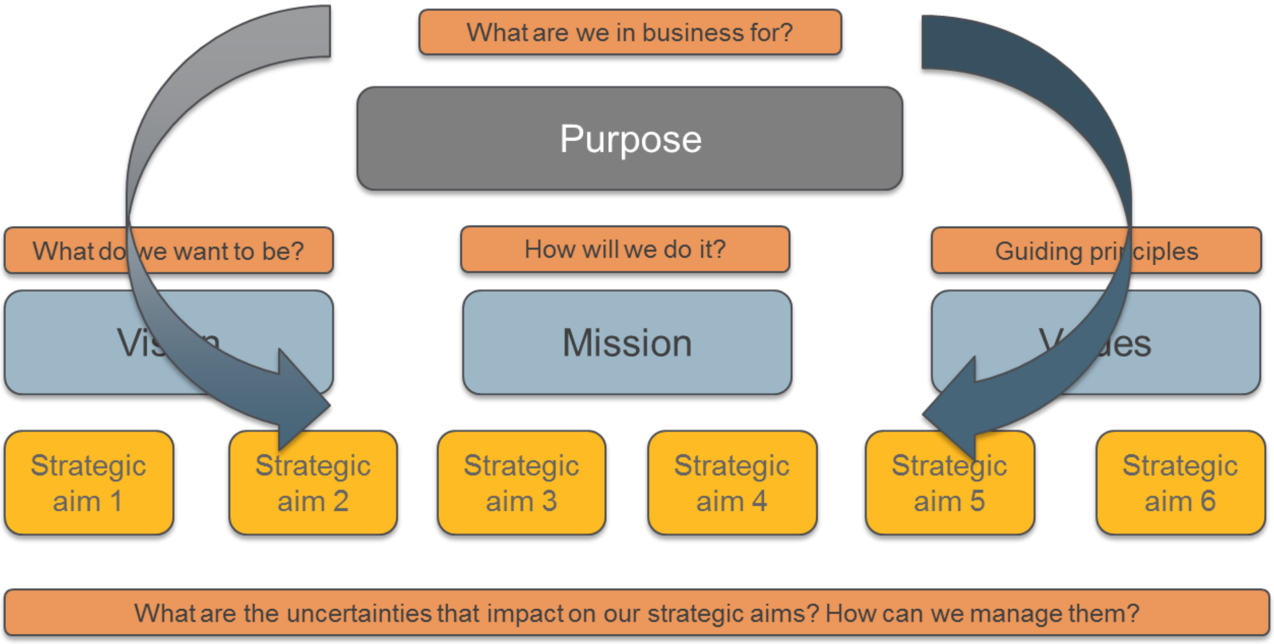

Figure 3, highlights that, to be truly effective, risk management should be related to the organisational strategy. The aim is to focus on the risks that could impact on organisational strategic aims.

This process can help embed risk management because it links risk management to strategy and critical success factors. This requires a focus on the uncertainties that might prevent the organisation from achieving its stated goals and objectives.

Linking risk management to strategy in this way puts risk management into context and within the understanding of all areas and staff.

In effect, asking individuals to consider what could prevent the achieving of the goals and these are often articulated as 'we wills' in an organisation's strategic plan.

This approach also lends itself to looking at mixed opportunities and not just downside risk.

A portfolio approach to risk

A Deloitte study concluded that 80 per cent or more of all major value losses involve the interaction of more than one risk. The study also indicated that many catastrophic losses are the result of a series of small events rather than a single large event.

Unfortunately, organisations that focus only on big risks may find themselves ill prepared to face the interaction of separate adverse events in the absence of an integrated and coordinated response to linked risks. Similarly, the exposure to a portfolio of risks needs to be considered.

For example, fundraisers are sometimes perplexed that a medium risk fundraising proposal is rejected when previously a high risk proposal was accepted. The point is that when you take a collective look at the whole organisation's risks, the portfolio of exposure can end up too high and the earlier acceptance of a high-risk proposal may mean that only low risk options can then be added to the portfolio.

Understanding risk vulnerability

Traditional risk management methodology focuses on considering both significance and likelihood or probability of a risk. However, probability has less value for risks that occur outside the normal fluctuations, for example, where the event is rare or unprecedented, where the rules are unknown or rapidly changing, or where causes are driven by external factors beyond the organisation's control. In such instances, the notions of vulnerability and risk interaction should assume prominence in the risk assessment and risk management processes.

If a risk is both relevant and has extremely high impact, it should be addressed, regardless of 'remote' likelihood. However, 'addressed', in this context, is not necessarily the same as 'mitigated'.

A balance needs to be attained and vulnerability should be weighed alongside probability. Non-profits are invariably resource constrained and risks and rewards will need to be considered.

However, it is important to recognise that sometimes improbable events do occur with devastating effect, while other times probable events fail to materialise. To ensure that risk management focuses on both value protection and value creation, management and the governing board must understand the possible, and its impact, and not just the probable.

Notes

Start the conversation

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