Board level risk identification

The unprecedented challenges of 2020 provide a significant opportunity for audit leaders to partner with governance leaders to improve risk management capabilities and reset the risks to the organisation while demonstrating not only the value of independent assurance but also the advisory role internal audit brings to the board.

Internal audit is a powerful board level influencer. In the wake of the COVID-19 crisis, your board may well be asking the question *what next?* Risk identification is not easy, and all board members should welcome independent assurance on the process they use to identify new and emerging risks, plus offer a sense check on their outputs.

The answers to these questions will invariably be hard to digest while still reeling and battling to recover from the economic and personal losses suffered during the pandemic; boards need a trusted advisor now more than ever.

This thought leadership piece explores:

- A need for **different thinking**: that includes exposing unknowns
- The board's **attitude to risk**: from aversion to seeking out risk
- Key barriers to robust **risk identification**
- The **role of internal audit** in improving board risk identification
- Why being a "wise old owl" ensures a balanced perspective to identifying risks and making informed decisions.

Different thinking

Experts, futurists, and risk managers have often highlighted the impact of a pandemic, yet the global crisis caused by coronavirus left most world and business leaders reeling. A 2019 research report across 195 countries found that none were fully prepared to handle either an epidemic or a pandemic.

An Institute of Risk Management global survey of almost 1000 risk professionals in April 2020 found that only 32% of organisations had pandemic as an identified risk and of those only 20% had taken action to prepare.

*Click thumbnail below to enlarge image.

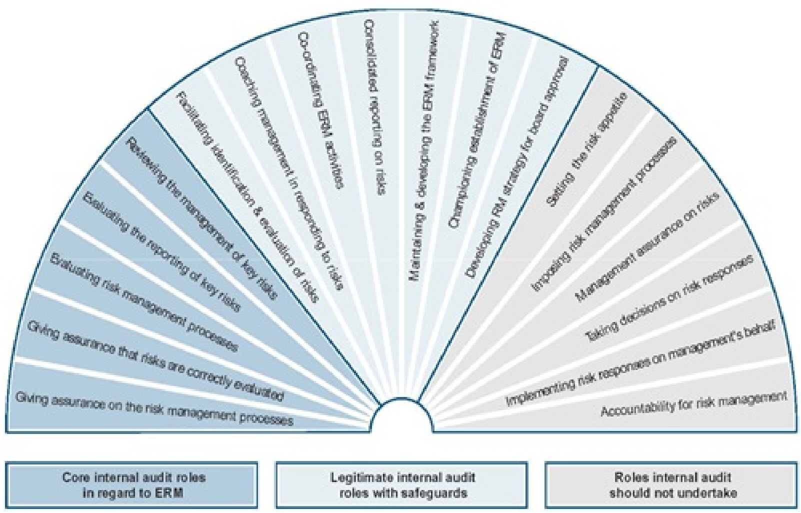


***Image credit**: Institute of Risk Management*

- Why is this?
- What was it that caused decision-makers to focus their attention on other matters?

This is a crucial question for audit leaders as futurist David Wood says, "bad though Covid-19 is, there are other scenarios for the next few decades in which much worse crises are credibly predicted."

In a more volatile environment, risk management capabilities could be the differentiator between organisations that are successful, those that struggle and those that fail.

During the coronavirus pandemic, some commentators referred to the situation as a 'black swan' event, others . Whichever school of thought you subscribe to; audit leaders must recognise the value of thinking about the unthinkable as possible when considering risk.

In the strictest sense, a black swan is something which lies outside the realm of expectations. A lighter definition is a surprising extreme event relative to normal beliefs and knowledge which could relate to:

- **Unknown Unknowns** – events that are unknown to experts and the scientific environment for example the effects of the thalidomide drug
- **Unknown Knowns** – events that those charged with identifying risk were unaware of or chose not to consider but where facts were available such as the events of
- **Known Knowns** – events judged to have negligible probability of occurring, which are notworth like the tsunami that destroyed the Fukushima Daiichi nuclear plant

Internal auditors may question the example of an unknown unknown in that testing should have identified the effects, or maybe that judgement is made possible by the benefit of hindsight. Whatever the definition of a black swan, those accountable for risk identification and analysis must work smarter with available information.

When providing assurance over risk management CAEs need to revisit their audit plans, their views on adequacy and the language used. Clearly what has gone before has not been sufficient. COVID-19 has been a game changer in many respects. The climate crisis will not be as forgiving.

- Which 'unthinkable' scenarios has your board explored?
- Was pandemic on your organisations risk register? If not, why?
- What assurance has been provided to the board in relation to risk management?

Whatever your answers, there is undoubtedly more that needs to be done.

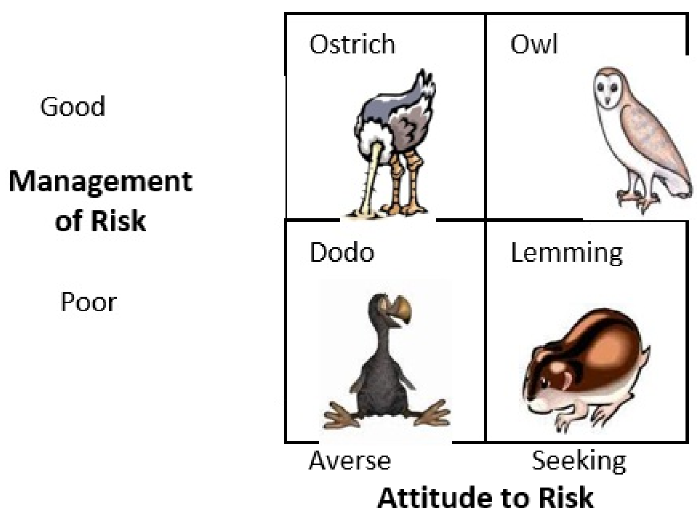
Attitude to risk

As with most concepts, the better they are understood, the more sophisticated attitudes become and the ability to engage with the concept itself. The boards collective attitude to risk is demonstrated through its risk appetite statements. Risk appetite itself is a complex subject for another day and guidance is available. For now, think of the boards risk attitude in one of two ways; either something simply to be managed away/avoided 'risk averse' or managed/harnessed 'risk seeking'.

In his book Smart Risk, Andrew Holmes combines an organisations attitude to risk (board risk appetite) with the ability of the organisation to manage risk (risk maturity) which leads to four types of behaviour, unapologetically linked to animal stereotypes; dodo, ostrich, lemming and owl.

This is a useful tool in working out how best to deliver assurance and advice to your board. The Institute advises a note of caution for any CAE thinking of sharing these animal characteristics though – is your relationship candid enough!?!

- Which of these resonates with your organisation?



Adapted from A Holmes, Smart Risk, 2004

Like the **dodo**, organisations that fall into this category are heading for extinction, a classic example is Kodak who failed to see the risks emerging in their environment and did not innovate despite having the capabilities.

An **ostrich** mentality is commonplace, organisations that develop robust risk management practices yet fail to acknowledge the upside of risk. It is a systemic issue even among audit and risk professionals, think for a moment about how many risk matrices you have seen that show the full risk continuum?

The board of a **lemming** organisation can be impulsive, overly optimistic or naïve in taking risk without having considered the consequences; the dot.com bubble in the late 1990's and some entrepreneurial ventures fall into this camp.

The wise old **owl** is the organisation with a balanced approach, able to identify risks and make informed decisions based on capability and capacity to manage both upside and downside risk. An organisation of this nature is likely to be sustainable and weather crisis.

Behaviour	Examples of value adding internal audit activity
Dodo	• Championing establishment of Enterprise Risk Management (ERM) • Developing RM strategy for board approval • Educating and coaching management to improve risk understanding
Ostrich	• Facilitating identification and evaluation of risks • Providing assurance that the process to evaluate risks is robust • Evaluating the reporting of key risks
Lemming	• Providing assurance over the management of key risks • Coaching management in responding to risks • Coordinating ERM activities
Owl	• Providing assurance on the risk management process • Support maintaining and developing the ERM framework

Barriers to risk identification

Members of the executive should aspire to be owls, if not individually then collectively as a board. Despite intelligence and expertise, individuals will invariably have barriers to risk identification which are rarely surfaced and addressed.

Being aware of these barriers is insightful for audit leaders when evaluating processes and discussing improvements.

1. **Risk expertise**

Internal auditors and risk specialists learn about risk management; it is a professional expertise. Conceptually it is still relatively new, Cadbury's ground-breaking report was only published in 1992. Many of the executives operating today will have only a practical appreciation of risk management they are often naïve to the concepts maturity journey that moves an organisation from an annual to an embedded process and from a risk register to active risk management.

2. **Heuristics**

These are the deeply rooted strategies or mental processes that we use to quickly form judgments, make decisions, and find solutions to complex problems often without even thinking about them. Availability heuristics for instance is potentially mankind's biggest weakness, having not experienced existential threats such as supervolcanos, asteroid strikes, climate change or (previously) pandemics our response is to ignore them as unreal. In the modern age it is not just natural events, imagine operating without the internet or if part of the national infrastructure was compromised such as telecoms or electricity.

3. **Knowledge**

Audit leaders can challenge the inputs to the board risk identification process. Do they take advice from subject matter experts, take time to read research reports, look at a wide range of information and gain insights from people with different perspectives? While the operational, compliance and financial risks are largely taken care of by the organisation as a collective, the pressure to 'mop up' and consider the strategic risks falls to the board; they are human and fallible with limited capabilities.

4. **Herd instinct**

Simplistically this is the parent of group think. At a board level, group think can be detrimental to risk identification and assessment due to dominant voices and closing down differing perspectives. Herd instinct is where people follow popular opinion in their risk thinking: could this have been a factor in the diesel emission scandal?

Each year, the World Economic Forum's Global Risks Report summarises the concerns of leading thinkers across multiple disciplines, however, it could also demonstrate a problem. In 2007 and 2008, pandemic risk was one of the top 5 risks in terms of global impact, (SARS pandemic 2003, Ebola 2014) it then dropped off the top 5 as mainstream focus and media shifted to climate change and so did the focus of the risks. In 2020 it was number 10 yet experts would argue that the impact had never decreased. Is it that all of the environmental risks genuinely have higher risk ratings or that their media profile has changed perceptions? Prior to coronavirus, headlines focused on climate change not pandemic.

5. **Bias**

Decision-making is influenced by the biases that affect individuals or groups. As a concept bias is often associated with recruitment decisions and that can be used by audit leaders to introduce it within the broader context of risk management. Bias is what causes people to dismiss events that are unlikely to occur as not worth thinking about or an event that has occurred as less likely to recur.

Relevant biases are summarised on page 19 of the May/June issue of Audit & Risk magazine.

Role of internal audit

Way back in 2009, the position paper The role of Internal Auditing in Enterprise-Wide Risk Management was published. It still holds true today and as organisations are faced with increasingly volatile and uncertain environments, it has never been more important for internal audit to act.

The famous fan is a powerful call to action.

- Which of the core roles does your function routinely perform?

- How many of the legitimate areas do you actively get involved with?
- Does your board take ownership of its accountabilities – the roles internal audit must avoid?

*Click thumbnail below to enlarge image.

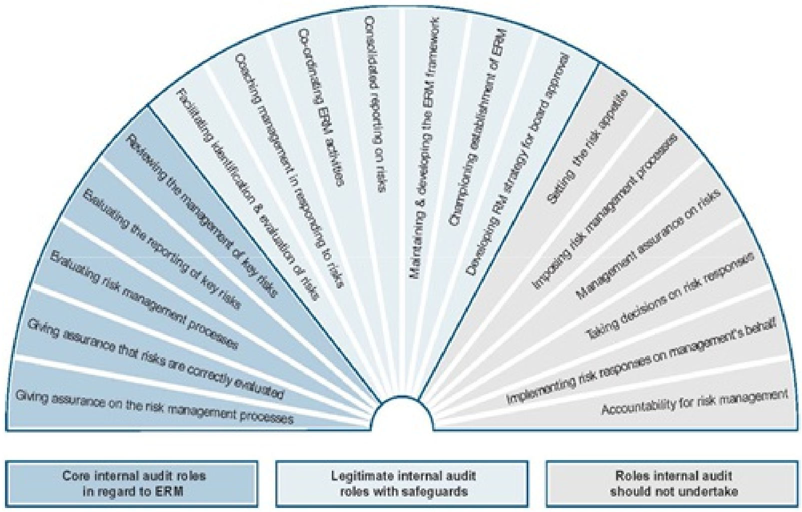


***Image credit**: The Institute of Internal Auditors*

Across the globe, many leaders were blindsided by the coronavirus pandemic. It is a stark warning of the need to improve risk management capabilities from risk identification through to reporting.

The board is negligent in its stewardship if it gives a cursory glance to a risk register once or twice a year. Likewise, a CAE is also at fault if that same risk register is used exclusively to produce a risk-based audit plan.

Risk management and assurances over it provided by internal audit must be meaningful – saying everything is ‘ok’ is not ok. There is a huge breadth of activity that internal audit can undertake in relation to risk management depending on the maturity of the organisation.

Many organisations do not have a dedicated risk function, which places internal audit as the risk expert and most importantly the risk champion. There is always a role to educate and facilitate thinking, whether working with dedicated risk professionals or simply when sharing audit findings with stakeholders.

Closing thoughts

Coronavirus has not only changed the face of society but the risk agenda. It is impossible to add hindsight to the risk identification process but ensuring the process is as robust as possible will help in an environment of heightened volatility and uncertainty. The board should be looking to internal audit to give them the risk management assurances to know that the processes in place to identify and assess risks are sound and that they are not simply ticking boxes or saying ‘we’re doing ok’.

"Let us be mindful that bigger waves are yet to come—from rising sea levels, increasing displacement, higher disease burdens and unpredictable environmental conditions."

Shivali Fulchand, Editorial Registrar, The BMJ

Risk resetting – recovering from COVID-19, World Economic Forum