

RISK INSIGHTS



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Risk, Response and Reduction } ENTITY

Strategic Emphasis Extends to Addressing and Reducing Entity-Level Risks

Organizations vary in their business strategies. A manufacturer may seek to enhance efficiency through outsourcing production to overseas contract manufacturers. A distributor may focus on becoming a one-stop supplier source for prospective customers. A utility may strive to be the low-cost provider in its regional service area.

Every business strategy carries risks. Recognizing the value of responding to risks and reducing vulnerabilities at the strategic level provides a foundation for addressing entity-level threats as they emerge. The response at the entity level assures that the threats an organization faces while executing its business strategies are met appropriately and within the entity's risk appetite.

Entity-level risks can arise out of a business strategy or from sources out of the organization's control. Entity-level risks are often created by external events, such as increases in prices for materials and supplies. Changing customer demographics may pose a threat to a company's existing market position and product offerings. New or revised compliance requirements present risks as well, as do changing international political or economic conditions for companies doing business abroad.

Internal events may also present new entity-level risks. A host of risks can arise in launching a new product, including

production difficulties or shipping delays and uncertain marketplace acceptance. Implementations of new IT systems present risks, including system incompatibilities or data security weaknesses not recognized during change-management planning processes.

When a company opens a new facility or expands an existing site, construction deficiencies not identified in previous inspections may require attention. New and approved interior design configurations might not readily accommodate actual work needs. Facilities at new locations are often staffed with newly hired employees who may lack the training and general experience necessary to resolve various dilemmas they confront.

Human resources risks arise, too, whenever there is turnover in key operational or management positions. Through years of service with a company, individuals acquire insight and institutional knowledge that cannot be easily replaced by even the most-qualified successors. Errors in judgment or execution can follow such transitions.

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Companies need to identify those and other entity-level threats through annual risk assessments. Based on those risk assessment findings, an organization can then address and mitigate those risks to ensure that any identified entity-level threats do not exceed the risk threshold accepted by management and the board when setting its business strategies.

Addressing and Mitigating Entity-Level Risks

Effectively responding to entity-level threats and reducing those vulnerabilities requires involvement from the audit committee, board of directors, and senior management, including the CEO, CFO and chief audit executive or chief risk officer, as applicable. Collectively, those individuals lead the organization in evaluating identified risks, analyzing the potential impact or likelihood of those risks occurring, and determining how any identified vulnerability is adequately covered within the organization's risk appetite and risk threshold.

Today, entity-level risks related to internal control over financial reporting are commonly identified along with the control activities designed to mitigate this risk. Operational entity-level risk identification and response documentation is less formal. An organization should seek to balance the entity-level risk assessment and design control activities to respond to risks proactively within the risk appetite of the organization. Consistent and visible high-level commitment from senior management and the board provides institutional support for addressing risks throughout the

organization, and nurtures a corporate culture that values recognizing and mitigating threats whenever they emerge.

An organization will always face uncertainty, and it cannot mitigate or eliminate every potential threat it faces. Taking a top-down approach toward responding to risks, however, assures that the greatest threats receive the greatest amount of attention and resources, and that the remaining vulnerability — the residual risk — remains within the organization's risk appetite.

Such a top-down approach considers general business conditions and industry-specific concerns, as well as external and internal threats unique to the organization and its business strategies.

All airlines, for example, face likely declines in air travel if a broad economic recession unfolds. Airlines share that crucial recession risk with businesses operating in a diverse range of industries. Fuel costs are a major operating expense for any airline, and rising fuel prices pose a significant risk for all companies in the air travel industry.

While facing such common threats, however, each airline also faces its own critical, unique entity-level risks. One airline's labor costs and pension liabilities may present substantial entity-level risk, making it especially vulnerable to any rising costs or declines in revenue. Another airline that handles considerable volumes of international travel may face threats from political instability in overseas regions it serves. A discount carrier whose business model is based on offering frequent short flights faces risk due to proposed

legislation that would restrict the number of departures and arrivals it can schedule during peak travel hours at its most popular airports.

Each organization must identify and address the most crucial entity-level risks that it faces as they relate to its business strategies and risk appetite. Such an approach assures that the most critical threats receive attention. The organization can then decide how to respond to those risks in order to reduce vulnerabilities within its risk profile.

Responding to Identified Risks

Based on comparison of an identified entity-level threat to its risk appetite, an organization can choose the most appropriate response to that risk. The COSO (Committee of Sponsoring Organizations of the Treadway Commission) Enterprise Risk Management Framework defines avoidance, reduction, sharing and acceptance as general risk responses.

An organization may decide that the likelihood or potential impact of an identified risk is simply too high, and that the most appropriate response is to avoid that vulnerability completely. A retailer seeking to expand beyond its regional market may decide that local competitors within a particular state are very well-entrenched. Because it could take an inordinate amount of time and resources to gain significant market share in that state, the retailer decides to avoid that risk by directing its current expansion efforts elsewhere.

Reducing risk is other option for responding to a recognized vulnerability. An increase in traffic accidents poses a significant entity-level risk for a package delivery company. To reduce that risk, the company implements more extensive defensive driving training programs for its drivers. It also purchases greater insurance to reduce its liability exposure in the event of accidents.

Sharing risk provides another option for mitigating an unacceptable vulnerability. An oil company discovers substantial new reserves. Exploiting those reserves, however, requires expertise beyond its exploration capabilities as well as massive, long-term capital commitments in a very cyclical industry. To share the risks that accompany exploiting those reserves, the company enters into a partnership with another oil company that specializes in oil field production.

An organization may also decide that an identified vulnerability is within its risk appetite and does not require further response. A domestic software developer, for example, may rely upon service providers in Asia to perform crucial tasks, including writing software code and providing technical support. Depending upon such distant operations presents numerous risks. However, the company has an

employee onsite at each service provider's location and utilizes real-time reporting systems to continually evaluate their performance. Because it feels its monitoring efforts are sufficient, the software company accepts the risks that accompany its outsourcing.

Responding and reducing crucial risks at the entity level complements an organization's efforts to address risks accompanying its business strategies. Focusing on risks at the entity level then leads to evaluations of the processes associated with those entity-level vulnerabilities. With such an approach, the organization addresses risks in a comprehensive, consistent manner.

Long-Term Benefits

Responding to entity-level risks and mitigating unacceptable vulnerabilities enables an organization to ensure that identified threats do not exceed its risk appetite. That protects the organization and allows it to pursue its business strategies.

Organizations operate in dynamic environments, and new risk exposures will always emerge. Addressing those emerging risks enables a company to minimize the degree of uncertainty it faces. Such responsiveness also uncovers opportunities that may have otherwise gone unnoticed and enables an organization to continually adapt and grow amidst change.

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Weaver and Tidwell, L.L.P., has offices in Dallas, Fort Worth, Houston, Austin, San Antonio, Midland and Odessa.

CONTACT US

ALYSSA G. MARTIN, CPA, MBA
Dallas Executive Partner

Alyssa.Martin@weaverllp.com
817.332.7905 or 972.448.6975

Weaver has offices throughout Texas.
More at weaverllp.com