Business Confidence Management

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SYNOPSIS

Business Confidence Management addresses the increasing need for effective risk manage-ment throughout an organisation. It helps businesses to comply with the latest Turnbull recommendations for corporate governance by a novel method of identifying and controlling risks. It uses non-attributable interviews to assess levels of confidence in achieving business targets. Where confidence is lower than expected, in conjunction with existing risk logs, the method helps managers to quantify business risks. An index can be calculated that provides a consistent, company-wide, ability to rank any risk. People can focus their risk reduction effort on the most important risks. This paper summarises the background and illustrates some of the benefits.

1. INTRODUCTION

Recent events have highlighted that events, once thought to be inconceivable risks, have resulted in the bankruptcy of major businesses. The Guidance for Directors on the Combined Code[1] and Implementing Turnbull[2] has now been inculcated into UK boardrooms. Directors must consider risks on a regular basis and affirm that managers are following appropriate risk management processes. All plc annual reports now contain a section about corporate gov-ernance, including commentary on risk management. Reuters' annual report [3] is a good example of the degree of disclosure that some companies feel is necessary – and which most companies should be considering internally.

Risk management has rather negative connotations. It is like searching for bad news. The process is likely to include a round the table session where managers are invited to bring along risks they have identified, or asked to brainstorm for new risks. Depending upon the organisation's culture, this could be a cathartic experience. Not everybody wishes to expose his or her potential risks in an open debate, and they may not surface. In some organisations, characters are so strong that hinting at criticism is not a career enhancing action. As a result, potentially catastrophic risks can be overlooked.
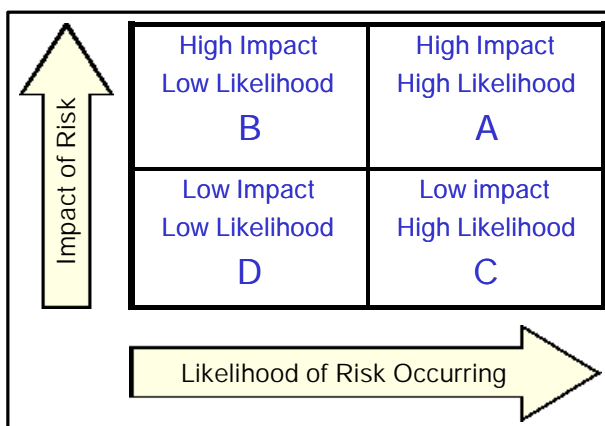

Fig 1   Turnbull – How to prioritise risks

Turnbull recommends a two by two matrix for prioritising gross risks (See Fig 1) by assign-ing a qualitative high or low opinion of both the impact of the risk and its probability (Turnbull uses the word "likelihood").

For deciding on further action, risks are prioritised and given a Type A, B, C or D rating, to be interpreted as:

A   Immediate action

B   Consider action and have a contingency plan

C   Consider action

D   Keep under periodic review

When this method is cascaded down into lower levels in the organisation, using such a simple matrix has two difficulties:

- People's opinions differ as to the definitions of "high" and "low", further complicated by the addition of "medium". Different departments and projects interpret the words in different ways; it becomes impossible to prioritise risks across a company.

- If there are many Type A risks (high probability, high impact) rated for immediate action, some Type B risks (low probability, but **very** high impact) might not reach the board's attention. One of these could be the catastrophic risk that ruins the company.

In summary, there are two problems to solve: firstly, identifying important risks and then introducing a common ranking system that is both simple and effective. The solutions are discussed in Section 2 and Section 3 respectively.

2. IDENTIFYING RISK

Business Confidence Management uses a top-down approach for identifying gross risks that is based on corporate, departmental or programme objectives. It supports the key Turnbull recommendations and helps to obtain management buy-in at all levels of the organisation.

2.1.   Using Confidence to Identify Risks

Rather than starting the search for risks in a negative way, the method uses the reverse psychology to ask about success – "How confident are you that targets will be met?"

New risks are identified within the total context of company goals and objectives. Furthermore, it adds a positive representation of the health of an organisation; visually, like a balanced scorecard or dashboard.
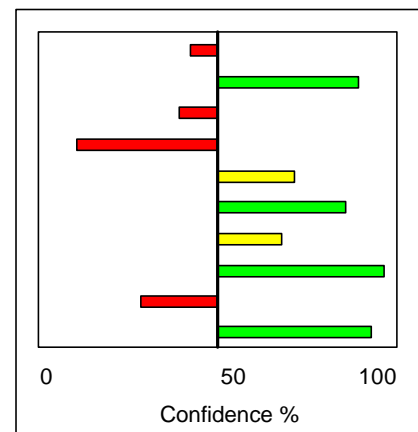

Fig 2   Confidence Chart

Fig 2 above shows that four targets have very low confidence of being achieved, two are in a zone which need attention to improve confidence, and four probably will be achieved.

Action can be taken according to the level of confidence:

- Where there is low confidence, less than 50%, then not reaching the target should be confirmed as a gross risk in the risk log. Immediate risk reduction action should be taken.

- For intermediate levels of confidence, say between 50% and 75%, there should be risk log entries reflecting the nature of the risks. The root cause for reduced confidence should be investigated.

- Even if there is high confidence of success, say greater than 75%, then there may still be a case for a risk log entry if the impact of failure is high.

The next step is to convert percentage confidence levels into risk probabilities.

$$\text{Risk Probability\%} = 100\% - \text{Confidence\%}$$

Without claiming intellectual rigour, a high confidence level, say 90%, means that there is a residual small risk probability, say 10%. Managers are comfortable with this concept - high confidence equates to low risk and vice versa. Discussion helps people to accept that simple quantification of risks is neither difficult nor threatening. It is analogous to high confidence computer systems[4] being used in areas where risk must be reduced.

2.2.   Method

Strategic objectives, quantified as far as possible, are reviewed with senior management and documented as a baseline for assessment (See Fig 3).
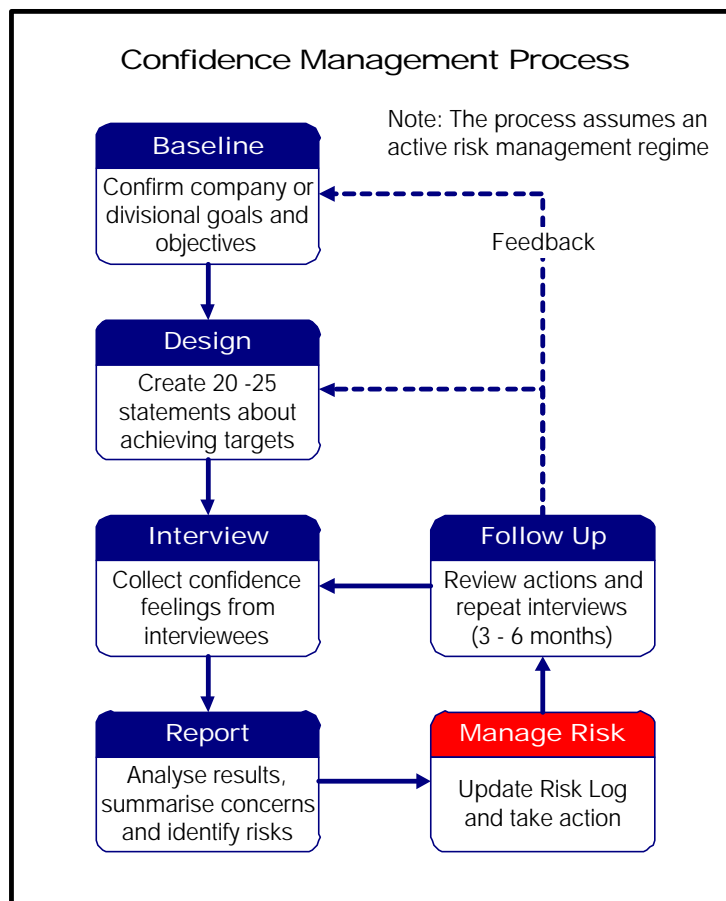

Fig 3   Confidence Management Process

Interviews are carried out using a one-page questionnaire that records levels of confidence. A five-point scale ranges from totally confident to minimally confident. Subsequently, values from 90% to 10% are allocated. The analyst can also select extreme values, say 100% or 0%, if the interviewee stresses strong opinions during the course of an interview. Interviewees are invited to comment on the reasons for their lower values. This may highlight the root cause of a risk, especially if mentioned by several interviewees.

To encourage open and frank responses, an independent interviewer asks questions in confidence and ensures that comments are not attributable to a specific person. Interview data is analysed and presented in a report. The contents include commentary on areas of high and low confidence and references to the risk log. Charts show average confidence levels for each target (see Fig 2) and the variability of the responses.

Second and subsequent reports discuss the change in confidence levels since the previous report. A change chart graphically indicates the effect of risk reduction since the previous review. The process provides feedback into the risk management control loop.

Most importantly it supports the risk management process by flushing out risks that may not have been formalised. In extreme circumstances, it could contribute to a decision to change the baseline business or project targets.

2.3. Experience

The method has shown benefits at a number of client sites, including major programmes valued at more than £100 million. Some key findings are:

- Confidential, non-attributable interviews help to open up discussions and identify root causes of problems. It allows comment at peer level that might not surface in the presence of overbearing managers.

- The initial interview requires a few minutes to explain the concepts and establish understanding of the business objectives. Subsequent interviews are quicker to execute and frank answers are obtained in less than one hour.

- The questioning technique encourages managers to think more quantitatively about business targets and the probability of achieving them. They feel comfortable that 90% confidence has a residual 10% risk, and that it is fair to include it in a risk log.

- Levels of confidence can diverge extremely between interviewees. Whether lack of communication or "head in sand", it is useful data worthy of further investigation.

- In programmes experiencing difficulties, the results provide a focus for debate at board level. One organisation used the results to support a major contract variation.

- Even with generally satisfactory levels of confidence, it is worth investigating the target with the lowest confidence. One internal audit team raised a security risk with an impact greater than £1 billion; procedures were tightened.

3. PRIORITISING RISK

The second part of the paper addresses the problem of finding a common method for prioritising risk, from corporate level down to an individual project. The new risk management standard[5] now promotes better quantitative definitions of risk impacts and probabilities. However, the boundaries are discretionary and it is difficult to set priorities if people stick with medium, high and low terminology. Other risk ranking methods eg Risk Matrix[6], use voting systems that are more difficult to implement across diverse organisations.

3.1. Crilog Risk Index

The Crilog Risk Index (CRI) evaluates risks consistently across whole organisations. In a scale ranging between 0 and 100, it gives a single value for any risk impact between £1000 and £10 billion. The absolute value is unimportant; it is only required for ranking purposes

and setting priorities for risk reduction action plans. A CRI value is calculated for every entry in a risk log. It is a logarithmic function of the probability and impact of the risk. After assurance that impact assessment only needs to be "order of magnitude", people are content to give approximate values.

The next stage is to highlight importance by generating a "Traffic Light" colour for each risk, see Fig 4. The ranges are arbitrary and can be changed at any time to suit the size and control requirements of an organisation.

Colour	Description	Action	CRI
Red	Potential disaster	Act now - advise directors	64 to 100
Yellow	High risk	Manage down	32 to 64
Green	Manageable risk	Monitor monthly	0 to 32

Fig 4   Crilog Traffic Lights

The major benefit of using this single value index is that it can be used on completely independent risks logs, whether they cover corporate, departmental or project risks. At any time it is possible to merge risk logs and present a consolidated view of importance.

3.2.   Risk Matrix

The CRI value can be used to great effect by using it as an indicator of importance in a matrix of impact versus probability, see Fig 5. The size of the risk circle is proportional to the CRI value, with the traffic light colour also highlighting the urgency of action required.
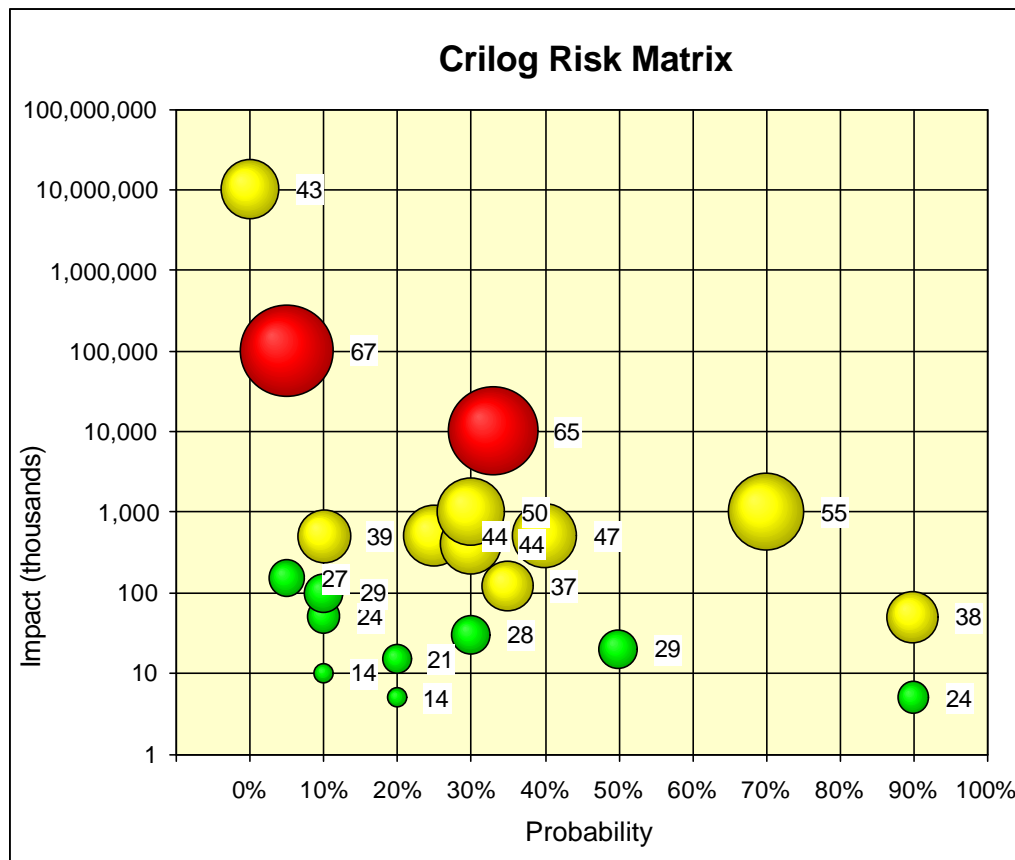

Fig 5   Crilog Risk Matrix

Compared to the simple High, Low axes used on the Turnbull[2] matrix (Fig 1), this chart graphically draws attention to important outliers, such as:

- Risks that are almost certain to impact the bottom-line performance of a company, Turnbull Type C (lower right hand side).

- Risks that could potentially destroy a company, Turnbull type B (upper left hand side). Low probability but **very** high impact.

Although it requires a culture change for people to allocate values to both the impact and probability of entries in the risk log, in practice it works well. People see the benefit of a simple method for ranking any magnitude of risk across different divisions or programmes. This change is fostered after people have been involved in a confidence survey. By accepting confidence measurement in a non-threatening environment, it is a small step to using percentages for risk probabilities and orders of magnitude for risk impacts.

The next stage of the development of the method could be to assess budgets for risk avoidance, contingency or insurance against risk events. It is also possible to construct probability matrices for business opportunities, or the "upside risk" referred to in the new risk management standard[5].

4. CONCLUSION

The Business Confidence Management process is a simple way to quantify levels of confidence in achieving business targets. Non-attributable interviews reveal new risks and information that may not be discovered using traditional techniques. It lowers the barriers to estimating the impact and probability of risks. By calculating the Crilog Risk Index (CRI), any risk can be given a value in the range of 0 to 100 that can be used to rank the importance of risks from any source. Boards of directors have a process available that consolidates a total risk profile of a company from independent operational risk assessments. This diagnostic tool could contribute useful data for compiling the annual compliance statement.

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