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# FACING RISK HEAD ON

Businesses are faced with many challenges; delivering products to market, making a profit for shareholders and operating in an ever-changing environment. Every franchise business is faced with risks that threaten or reduce its ability to function. Managing these risks and monitoring the effectiveness of internal controls are critical for preventing or minimising the irreparable damage that risks can have on a business.

Risk management is a crucial defensive and offensive strategy for any franchise business, large or small. Risks and internal controls are often overlooked by businesses and only tend to be considered after a serious event has occurred. Preventative measures are often a low cost way to minimise or even eliminate the risk of irreparable damage.

A risk management and internal audit framework ensures that franchisors and franchisees have a comprehensive approach for identifying, assessing, evaluating, managing and testing business risks – whether it is a customer potentially slipping on a wet floor, fraudulent activity or an unexpected natural or human-induced event. A risk can encompass anything that may affect a business in terms of operations, finance, strategy and compliance. These risks can stem from triggers such as economic, technological and people factors.

The following steps outline the process used by businesses worldwide, regardless of size or industry, in identifying and managing risk:

## 1. RISK IDENTIFICATION PHASE

The purpose of the risk identification phase is two-fold; establish what, where and when an incident can occur, as well as why and how it can happen. This phase of the process is reliant on your ability to satisfactorily understand business functions and to apply your experience to clearly identify what can go wrong.

**Steps for identifying risks include:**

- One-on-one discussions with all members of the senior management team to establish views and risk context. This is an important step as it is senior management who are responsible for risk and drive the organisation's strategic goals and objectives.
- For the next tier of management, discussions are replicated with more targeted risk identification discussions. This may include risk workshops with key team members responsible in various areas of the business, including purchasing, sales, operations and marketing.
- System reviews should be undertaken to identify potential weaknesses in key processes.
- Lower level discussions, including use of information gathering tools such as questionnaires, should be conducted to identify 'on-the-ground' risks.

Ideally, discussions should also take place with other stakeholders to further establish risk context.

Risk identification should also include any human-induced or natural events that may occur. As an example, a customer operating in the entertainment industry had invested heavily in the IT systems of their Melbourne head office. As a result of their investment and risk management planning, they decided to replicate their head office operating environment in a virtual sense at an alternative location. Months after this had been completed, their office was severely damaged by a hailstorm with, unfortunately, most damage occurring to their major IT infrastructure (servers, data storage etc). By having their systems stored at another site, they were able to switch over to the other system and were back up and running the next day – without any loss of data and minimal disruption to operating activity.

## 2. RISK ASSESSMENT AND TREATMENT PHASE

This phase is concerned with evaluating existing controls and establishing a priority for the risks identified in the initial phase. A key outcome of this will be a list of control gaps with alternatives provided to help mitigate the risks faced by the business.

It's important to note that risks can be both positive and negative. We all focus on the negative risks, but what if something good happens and you are not prepared for it or the business opportunities that might stem from that risk being taken.

One of our customers is facing a risk 'head-on' by considering how they currently do business with government entities. In order to work with government customers, a business must comply with various requirements as well as invest in the preparation and submission of tenders – that may or may not be successful. Although there are risks associated with this, the potential is there to win new business that may not have otherwise been possible. However, by conducting a risk assessment, our customer may decide that this potential revenue stream may not be worth pursuing if the potential costs outweighs the benefits.

**Steps for assessing and treating risks include:**

- Evaluating existing controls within the organisation to determine the risk severity and likelihood of identified risks occurring. This step is critical in determining what will be required by the organisation in mitigating or transferring high priority risks.
- Assessing risks as objectively as possible using qualitative and quantitative methods.
- Producing a priority list of risks that is commensurate with the risk appetite of the organisation. From this, more specific control gaps can be identified.
- Supplying recommendations on how all high priority risks should be addressed by the business.

## 3. MANAGING RISKS PHASE

Once the risk identification, assessment and treatment phases have been completed, the result will be risks that have been or could be:

- Transferred – risks that can be insured against.
- Avoided – risks that won't be pursued by choosing not to take the risk, for example, deciding not to pursue government business.
- Residual – risks that effective controls need to be designed and implemented for. These risks will also continue to be audited to ensure controls are effectively working to mitigate the risk.

When it comes to managing risk, there are three lines of defence. The first line of defence is divisional management and the board, the second line is risk management, and the third line is assurance providers such as internal auditors, external auditors and other compliance experts.

## RISK MANAGEMENT AND LINES OF DEFENCE

Third line defence can provide franchisors and franchisees with assurance that they may not otherwise receive. One recent project for a customer involved a review of their vendor masterfile and accounts payable transaction data. As a result of our review, we found instances where suppliers had been paid twice, vendor masterfile information was not complete and other exceptions that suggested internal controls and processes weren't working effectively. This highlights that designing the 'right' internal controls and testing them regularly for effectiveness is critical to managing risks.

## 4. TESTING FOR RISKS

Regular testing of key internal controls is essential if the success of business processes is to be known. The preparation, planning and testing of risk management processes can reduce or limit the effect of a risk on business operations. Moreover, testing can increase staff awareness and ownership of risk procedures, assist in keeping risk management plans updated and ensure staff can operate with limited facilities.

## RISK BASED INTERNAL AUDIT PROGRAM

Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. Risk management should become an integral part of business systems to add value and increase productivity. A risk based internal audit program can assist businesses in identifying, assessing, treating and managing risks. The internal audit program is developed by third line defence agencies in conjunction with the business.

**The outcomes of a risk based internal audit program include:**

- A prioritised list of relatively high risk business cycles provided to management with discussions on the areas that could form part of an initial internal audit program.
- An internal audit plan developed to monitor the control effectiveness of business cycles – identified as being of the highest risk.
- Audits conducted on business cycles based on the risk outcomes and discussion with senior management.

Preventative measures such as risk management and internal audit planning and controls can greatly reduce the irreparable damage of risks on a business. They can provide franchisors and franchisees with assurance and protection as well as identifying risks that may not have been considered or initially perceived as risks. They can also enable a business to continue operating – even if faced with an unpredictable natural event. By design, risk management and internal audit frameworks add value, increase the productivity of a business and assist in achieving its goals and objectives.

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Peter is a respected advisor to Australian and international corporations in the risk and internal audit field with over 15 years experience with a particular focus on retail businesses including experience with franchise systems.

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