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Creating Value Through Board Excellence
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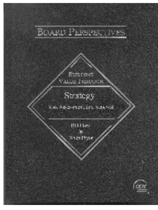

Private Directors Association Recommended Reading:
Board Perspectives: Building Value through Strategy, Risk Assessment and Renewal
By William J. Hass and Shepherd G. Pryor IV
CCH, January 5, 2006
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PDA Newsletter June 2016

Your Company Should Have a Risk Matrix

Upcoming Events

Aligning Officer Compensation with the Needs of a Family Owned Business

June 15, 2016
5:30 PM to 7:30 PM

Seyfarth Shaw
131 South Dearborn Street
Suite 2400
Chicago, IL 60603

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Five Questions Every Director, CEO, CFO, and Controller Needs to Address to Understand Risk and Value:

1. How do we communicate about the risks our organization faces and how they might impact our company's ability to build and protect value?
2. What is our appetite for accepting risks that can or cannot be insured?
3. How frequently do we update and discuss a risk matrix with our leadership team?
4. How do we demonstrate a realistic "outsider's view" and incorporate critiques to our risk assessments?
5. How do we prioritize actions to mitigate key risks, assigning a manager to develop and monitor mitigation plans and "What-If" scenarios?

You Cannot Manage Risk, if you do not Measure Risk!

While measuring risk is not easy, it can be done by relating the measurements to some benchmark, such as a coin toss. Risk management has been in the headlines for large organizations for almost 15 years as a result of corporate missteps and resulting regulation. Large organizations now have risk managers that help them design and maintain detailed risk management systems and programs. In smaller and mid-market firms, though, the CEO, CFO or Controller must wear many hats, including that of the "Risk Manager."

The Board of Directors is the custodian of corporate value. Experience shows that every organization can create more value for its stakeholders with a better understanding and communication of the risks they face. The "Risk Matrix" is a one-page summary tool to build understanding and communication about risk.

Risk management has been mandated for public corporations by government regulation in many very specific ways. The practice and tools of risk management are now widely known, documented and accepted in large organizations with significant incentives provided by numerous regulatory mandates. Large financial institutions have rigorous requirements for compliance including annual "Stress Tests" and creation of "Living Wills" should there be a catastrophic failure.

However, despite the growing awareness and practice of risk management, most private small and mid-market companies are far behind in thinking and management of risks. That is until an unexpected event happens and it is too late to mitigate the risk. These organizations can benefit from the relatively small investment of time needed to begin the process to develop and share a basic risk matrix. The risk matrix, like other one-page tools, will help communicate important threats and opportunities among the owners and the senior team. Once risks are put on paper and defined, the debate begins as most of these risks can be insured, hedged or mitigated in some way.

Risk Matrix: Only One Tool in a Comprehensive Risk Management Program

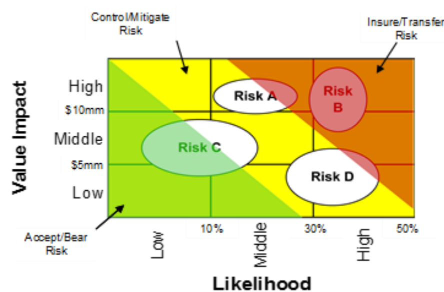
A good insurance broker can help the small and mid-market company get started. Insurance brokers have the basic benchmark data that define the typical risks that are common in most industries. Because insurance companies have benchmark data on risk, both insurable and non-insurable but manageable, a good broker can provide guidance on both insurable and other risks that can be mitigated through process improvement or organizational changes.

Experience shows that risk mitigation programs and stress testing can add great value by reducing potential losses. Financial executives should be experienced with the typical risks facing all organizations today including the basic four risks from the basic COSO Framework:

- Strategic Risk: e.g. risk from potential disruptive technologies
- Operations Risk: e.g. cyber risk and supply chain risk
- Reporting Risk: e.g. misstatements to owners or regulators
- Compliance Risk: e.g. risk and cost of safety regulations, consumer regulations, etc.

Strategic risks are even more critical in small and mid-market companies because one event can mean success or complete failure. The digital revolution is changing all industries in many different ways from customer care strategies to sourcing strategies.

Trucking Company Example: The CFO of a $70 million trucking company uses a facilitator to conduct an afternoon session of the senior management team to explain the concepts behind the risk matrix and develop a first pass. After some refinements, the preliminary risk matrix is presented for discussion at a quarterly board meeting. The board finds it interesting and asks some probing questions and for further refinements. After some refinement, it was presented to the board in a more formal mode as shown.



Risk Indicator	Risk Impact ($MM)	Lilihood (Probability)
Risk A	$10-12	10-25%
Risk B	$7-14	30-40%
Risk C	$4-9	5-20%
Risk D	$2-6	25-40%

After a report that another trucking company filed Chapter 7 bankruptcy due to a multi-truck accident that exceeded its insurance coverage, the company increased its insurance coverage to provide against a catastrophic accident. Succession of the CEO was identified as a risk and succession plan was started.

Five Steps Easy Steps Can Get You Started:

Five steps can get the top team of any company started with or without a facilitator.

1. Identify 5-10 key risks in words. Refine priorities to keep the list manageable.
2. Estimate a "Range of Magnitudes" (rough ranges are OK).
3. Estimate a "Range of Likelihoods" of an event occurring over a 3 to 5-year period. Consider relative risk of those chosen vs. a flip of a coin (50/50) or remote (1/1000).
4. Plot the "Events" on a Risk Matrix. If there is uncertainty about the impact or likelihood, show a range as a larger circle or ellipse.
5. Use the matrix to share and communicate the estimates of risk magnitude and likelihood and discuss early warning indicators and how to mitigate key risks.

Typical benchmarks that could be used to calibrate a risk matrix to the value of a business or organization can be designed based on the organization's risk appetite.

Magnitude of an event involving loss of Value:
Catastrophic: over 50% losses of value and Potential Bankruptcy
High: 30-40% loss of value
Meaningful: 20-30% loss of value, e.g. The loss of your biggest customer
Moderate: 10 % loss of value
Low: Less than 5% loss of value, e.g. A mid-sized customer loss

Likelihood of an event involving loss of Value: All risks are relative.
Rare: Less than 1 of 10,000 (Tornado destroys facilities)
Unlikely: 1 of 100 *Possible:* 1 of 10 (Loss of a major customer or the CEO)
Likely: 1 of 3
Almost Certain: 1 of 1 (e.g. Our restaurant will have a slip-and-fall lawsuit every year)

This article is adapted from Chapter 6 of the book: Board Perspectives: Building Value through Strategy, Risk Assessment and Renewal, by the authors.

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