CA FINAL

RISK MANAGEMENT

IN-HOUSE

CASE STUDY SERIES

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Case Study 24 Questions

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Case Study

Management accounting texts usually describe risk through techniques such as probability, decision trees, standards deviations and portfolio analysis. While there have been many studies of bias, participation, performance evaluation and dysfunctional behavior in relation to budgeting, there has been little research into risk in the process of budgeting.

This is why CIMA funded a pilot study to understand how managers perceived and managed risk in the budgeting process. Risk was defined as the consideration and consequences of unpredictable and uncontrollable events, and of perceptions about those events. The study considered risk through an exploratory and comparative pilot study of four organizations, identified as A, B, C and D.

'A' was a single customer plant of a multinational Fortune 500 automotive parts supplier, an assembler and sequencer of parts that exhibited the characteristics of a multinational;

'B' was a manufacturing firm. It was a subsidiary of an unlisted management buyout, which was heavily financed by a number of institutional investors;

'C' was a public-sector organization, a non-metropolitan police force;

'D' was a voluntary-sector organization that provided direct services to clients through funded project, and also contributed to national policy debates.

Researchers used interviews, documents and their own observation to gather data. Each of the case study organizations was facing a mini-crisis involving risk at the time of the research.

A undertook all the ordering and scheduling for its customer, and was responsible for just-in-time delivery to the production line in the correct sequence. The customer's assembly line dictated volume, on which A depended. A had been negotiating prices for replacement volume because of a reduction in production volume. A also faced unpredictability because the customer could change the build specification at short notice. The requirement to carry sufficient stock meant that A's margin was eroded by premium freight costs caused by production changes at short notice or supplier failure. A was therefore heavily reliant on its systems to avoid these costs, and used specialist IT and logistics subcontractors to reduce its risk.

B was struggling with problems because the investors’ three-year exit strategy had been missed as a result of the group’s poor financial performance. The company itself was profitable, but B had not informed employees of this for fear of resistance to restructuring and increased wage demands. The company’s main concern was decline in sales owing to its inflexibility and poor on-time delivery performance. B’s equipment was old and designed for large volumes of similar parts, in a market that had changed to low volume, high variety parts. Standard costs were “massaged” where equipment was used below capacity, as utilization rates led to that which were too high. While the old plant meant that most assets were fully depreciated, new capital investment resulted in substantially increased depreciation costs and pressure on finance from sales not to reflect the increased cost in the standard, which would make products too expensive.

In the public sector, C had to deal with the problem that demand for police services is unpredictable. The likelihood of major incidents was believed to be low but it was still possible. Funding such incidents, as well as police pensions that were part of a nationally unfunded scheme, had to be met out of current budgets or reserves. This meant that it could have a major effect on police work. The key issue for managers was how to achieve non-financial performance indicators, despite falling numbers of police officers caused by financial pressures. The gap between the required budget and the central government contribution had to be met either by further cutting the number of officers or by increasing the police levy. C provided five options to the police authority, ranging from staff cuts to restoration of earlier reductions. Once the precept was, decided, the budget was considered low risk because predictable income arrived on known dates and the volatility of payroll related costs was low.

In the voluntary sector, D delivered services in a variety of ways, most commonly through projects funded from its own resources and by government departments and agencies. An important aspects of risk management was the management of its reputation. Exposure of incidents in the past (for example, abuse in children’s homes) had caused bad publicity and fundraising had become more difficult. Project finance was available for new initiatives, subject to competitive bidding against tender specifications, but government funding was available only for new work, not to continue existing work. As a result, new projects had to be created in line with changing policy objectives. External funding bodies had become much more demanding about out-comes, management process and assessing the value of the work.

Multiple Choice Questions

(2 $\times$ 5 = 10 Marks)

1. At which stage the internal auditor would need to concentrate more on carrying out process audits of the risk management processes and especially reviewing the risk assessment process

A. Low-risk maturity

B. Risk naive

C. High-risk maturity

D. Risk-aware

2. The..................should look at the big picture and identify not only short term risk factors but also long term factors impacting the entire value chain of business activities and connected communities.

A. Enterprise risk management

B. Risk management program

C. Operational risk management

D. Organization

3. Various activities are included in the enterprise management framework except for:

A. Undertaking control and other response activities.

B. Communicating information on risks in a consistent manner at all levels in the organization

C. Centrally monitoring and coordinating the governance risk management processes and the outcomes.

D. None of the above

4. ....in an organization minimizes the impact of risk on the business with the help of a chief risk officer or a risk committee, but it does not give a guarantee that the organization will become risk- free.

A. Operational risk management

B. Enterprise risk management

C. COSO framework

D. Risk management

5. ....serves as a strategic analysis tool, cutting across business units and departments, and considering end-to-end processes.

A. BCP

B. VAR

C. BIA

D. None of the above

Descriptive Questions

6. Explain the need for incorporating risk into the budgeting process. Define the ways through which risks can be incorporated in the budget.

(6 Marks)

7. Explain the risk budgeting processes in the four organizations.

(9 Marks)