



Financial Sustainability Program

Information Paper 22

Establishing a Risk Management Plan

December 2009



Introduction

In its 2005 Inquiry the Financial Sustainability Review Board highlighted the need for strengthened policy frameworks and improved financial governance in Local Government. The LGA's Financial Sustainability Information Paper 11: *'Governance in Local Government'* describes, in its five core principles for good governance, the need for Councils to:

'Make sure that an effective risk management system is established, implemented and reviewed regularly' (page 5).

This *'Establishing a Risk Management Plan'* information paper outlines the key steps that Councils should undertake to implement a risk management approach to their various programs and activities. The paper includes, at Attachments A and B, an example of the application of the risk management approach to a Council's procurement activity.

This paper should be read in conjunction with a paper titled *'Business Risk and Opportunity Management – Developing a Risk Management Framework for Councils'* prepared by the LGA as part of its Better Governance Program and available on the following link: <http://www.lga.sa.gov.au/site/page.cfm?u=268>. Other financial sustainability information papers, but in particular Information Paper 11: *'Governance in Local Government'* and Information Paper 23: *'Financial Governance'*, also provide information relevant to Councils' risk management considerations.

Other financial sustainability information papers have been, or will soon be, prepared on the following topics:

- Financial Sustainability
- An Overview of Audit Mechanisms
- Audit Committees
- Scope of External Audit - Audit Specification
- Efficiency and Economy Audits
- Infrastructure and Asset Management (Policy and Planning)
- Service Delivery Framework including the Role of Shared Services
- Long Term Financial Plans
- Local Government Financial Indicators
- Debt Management
- Governance in Local Government
- Targets for Local Government Financial Indicators
- Model Framework for Council Annual Business Plans
- Model Work Program for Council Audit Committees
- Treasury Management
- Long Term Financial Plan - A Model Format for Financial Information
- Depreciation and Related Issues
- Financial Policies
- Audit Committee Reporting
- Funding Policies and Strategies
- Internal Financial Controls
- Financial Governance
- Audit Management Letter

A number of manuals, guidelines, templates, technical definitions, codes, standards and similar documents supporting this series of information papers are also being prepared by the LGA to provide practical assistance to Councils.

For an update on which information papers have now been completed or information about other documents and activities, including briefing and training sessions, please visit our website at: www.lga.sa.gov.au/goto/fsp.

Legislation

The concept of risk management is wide ranging with a variety of applications to matters concerning Local Government. There is no all-encompassing legislative provision requiring Councils to implement a risk management approach, however there are references within the Local Government Act, 1999 that require Councils to adopt appropriate policies, practices and procedures that ensure their assets are protected through sound administrative management. Under the Act Councils' Audit Committees are responsible for *'reviewing the adequacy of accounting, internal control, reporting and other financial management systems and practices of the council on a regular basis'* (Section 126 (4)).

Local Government also has obligations, from a risk management perspective, under other legislation such as the Occupational Health, Safety and Welfare Act 1986, Environment Protection Act 1993, the Development Act 1993, Public and Environmental Health Act 1987, Food Act 2001 and the Fire and Emergency Services Act 2005.

The adoption of a risk management approach provides a methodology for Local Government to improve its financial governance practices and meet its risk management legislative obligations.

What is risk management?

Risk management refers to a structured approach to identifying, evaluating and managing risks. It describes a proactive undertaking that Local Government can use to address threats and lost opportunities in relation to its interests.

The benefits of a coordinated, systematic approach to risk management include:

- The Council and its Chief Executive Officer and senior management have a clear understanding of the key risks facing the Council;
- There is agreement across the organisation on the priorities to manage the key risks;
- Various controls are in place and operating effectively to reduce risks to acceptable levels;
- Cost savings are achieved for Council through the presence of an efficient controls environment;
- The community has increased confidence in the operation of the Council.

Establishing a Risk Management Plan (RMP)

The risk management approach outlined in this paper provides a systematic methodology consistent with the Australian Standard AS/NZS 4360:2004 Risk Management, which sets out a 5-step process with continuous communication and consultation and ongoing monitoring and review.

The steps involved in a risk management approach are summarised as follows:

1. Establish the context
2. Identify the risks
3. Analyse the risks
4. Evaluate the risks
5. Treat the risks

These steps are addressed in turn below, and a worked example of how the theoretical model might be applied in practice, in the context of procurement, is provided at Attachments A and B.

Councils are encouraged to adopt and maintain robust RMPs based on the approach outlined in this paper.

1. Establish the Context

Establishing the context within which a Council assesses its risks requires an examination of the external, structural and operational environment within which the Council operates. As part of this process the goals, objectives, scope and parameters of the risk management process should be identified. Establishing the context also refers to the development of risk criteria against which risk will be evaluated.

Effective determination of the context of risk assessment provides a Council with the means to direct and control the limited resources it has towards the achievement of its aims in the most efficient manner.

The Australian Risk Management Standard defines risk as “a chance of something happening that will have an impact on objectives”. To Councils, this may be regarded as:

- any threat to meeting its objectives;
- any opportunity foregone to meet its objectives.

Councils are well aware of what constitutes occupational health and safety risks, for example, and management systems have been in place for many years to ensure these are managed and minimised.

The purpose of a risk management approach is not to eliminate all risks but, rather, to reduce them to a level acceptable to a particular Council in accordance with its risk tolerance limits.

2. Identify the Risks

In order to ensure that the RMP addresses all risks that impact on the achievement of a Council's business objectives, periodic risk identification reviews should be undertaken and a database of all relevant risks maintained. These reviews should take particular account of changes in the Council's business or operating environment and include the identification of all risks which impact on the achievement of its business objectives, regardless of whether or not they are under the Council's control.

Approaches used to identify risks may include:

- Brainstorming sessions;

- Review of audit findings;
- Assessment of historical incident data;
- Process flow charts;
- Assessment of third party contracts;
- Ongoing project management; and
- Scenario analysis.

In order to ensure comprehensive identification of all relevant risks (where these risks lie within the organisation) and the formulation of appropriate treatment plans, risks should be grouped into broad categories along the lines of the following:

- Asset management
- Business development
- Compliance
- Financial
- Governance
- Human resources
- Information services
- Procurement
- Project management
- Strategic management
- Environment
- Public relations

3. Analyse the Risks

Risk analysis describes the process of determining the level of inherent risk associated with a particular issue before taking account of any mitigating factors or controls in place. The analysis is based on an assessment of the **risk likelihood** (how likely is it that the risk event will occur) and **risk consequence** (what is the possible magnitude of the risk event), which in combination determine overall inherent risk ratings.

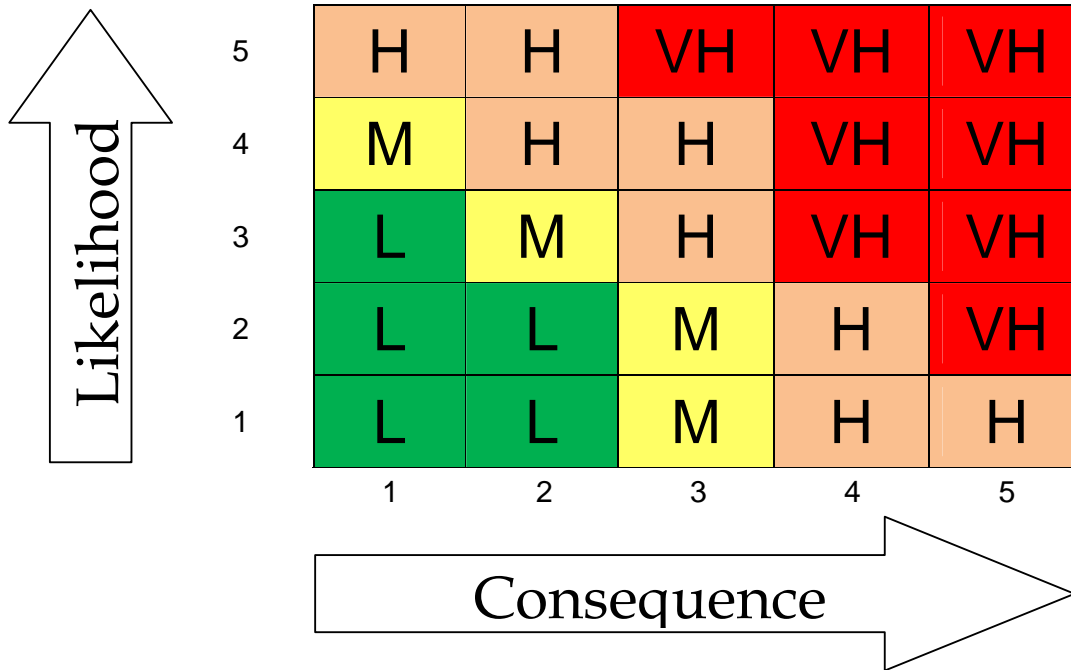
Risk Likelihood may be assessed on a scale of 1 to 5 as follows:

1	Rare	The event will only occur in exceptional circumstances.
2	Unlikely	The event is not likely to occur within the planning period.
3	Possible	The event may occur within the planning period.
4	Likely	The event is likely to occur within the planning period.
5	Almost certain	The event will occur within the planning period.

Risk Consequence may also be assessed on a scale of 1 to 5 as follows:

1	Negligible	Minimal, no injury or barely noticeable detriment.
2	Minor	Immaterial, slight injury or insignificant deficiency.
3	Moderate	Material, considerable injury or partial deficiency.
4	Serious	Severe, extensive injury or significant deficiency.
5	Critical	Catastrophic, fatal or complete failure.

Once the likelihood and consequence have been assessed for a particular risk the overall inherent risk can be determined by referencing an overall risk management matrix which reflects Council's risk tolerance:



In the matrix above, the following abbreviations are used:

- L Low
- M Medium
- H High
- VH Very high

4. Evaluate the Risks

The purpose of risk evaluation is to make decisions about which risks need treatment and the treatment priorities. The risk evaluation step brings in an assessment of management processes (controls) and mitigating influences that may combine to reduce inherent risk to some degree.

This step involves the identification, documentation and assessment of these influences, which may be rated as follows:

Control/Mitigating Influence Assessment	Description	Control/Mitigating Factor
Unsatisfactory	No systems or processes exist to manage the risk.	Inadequate
Poor	The systems and processes for managing the risk have been subject to major change or are in the process of being implemented and their effectiveness cannot be confirmed.	
Satisfactory	Systems and processes exist which partially mitigate the risk.	
Good	Systems and processes exist which manage the risk. Some improvement opportunities have been identified but not yet actioned.	Adequate
Excellent	The systems are effective in mitigating the risk. Systems and processes exist which manage the risk and management accountability is assigned. The systems are well documented and regular monitoring and review indicates high compliance with the process.	

The elements that may be taken into consideration when assessing controls and mitigating factors associated with a particular risk include:

- Design
- Cost
- Communication
- Operation
- Application
- Documentation
- Defined responsibility and accountability
- Monitoring and review procedures

The combination of the assessment of inherent risk and associated controls/mitigating factors results in a determination of “residual risk”, which will determine the appropriate treatment action required by Council.

The following table provides an example of the residual risk and appropriate treatment action arising from various combinations of inherent risk and control/mitigating factors:

Inherent Risk	Control/Mitigating Factor	Residual Risk	Action Required
Very high/High	Inadequate	Very High	<u>Active Management</u> Preparation, active review and management of treatment options.
Very high/High	Adequate	High	<u>Control Critical</u> Continual monitoring of controls to confirm assessment of effectiveness.
Moderate/Low	Inadequate	Moderate	<u>Periodic Monitoring</u> Improve control or continual monitoring of residual risk.
Moderate/Low	Adequate	Low	<u>No Major Concern</u> No action required. Consider reallocation of control resources.

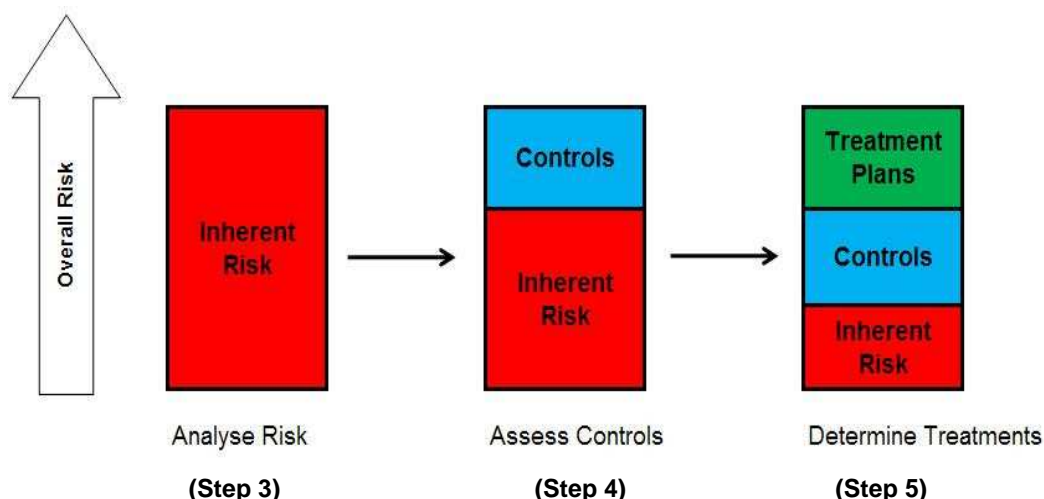
5. Treat the Risks

Risk treatment involves identifying treatment options, assessing these options and the preparation and implementation of treatment plans. As an example, for those residual risk exposures that are classified as “Active Management” a way of further moderating the risk is through the identification of options to treat the risk. Appropriate treatment plans will vary with circumstances, but should be developed within Councils’ strategic and long-term financial and asset management plans. This may be done purely on a cost-benefit basis, however it is conceivable that legal or other (e.g. social or environmental) responsibilities may override these considerations.

Good treatment plans should include the following elements:

- Specific actions;
- Resourcing;
- Delegations;
- Timing;
- Definition of key performance indicators; and
- Communication, feedback and control.

The intended effect on identified risks of applying steps 3 to 5 above is illustrated as follows:



Ongoing Procedures

Communication and Consultation

Communication and consultation are important during each step of the risk management process. Effective communication is essential to ensure that those responsible for implementing risk management, and those with a vested interest, understand the basis on which risk management decisions are made and why particular actions are required. It is important that a communication approach recognises the need to promote risk management concepts across a broad spectrum of management and staff.

Participation, interaction and two-way reporting are regarded as key features of an effective risk management approach. Effective communication and consultation will help to ensure that the risk management process is fully informed at all stages and to promote ownership and acceptance of the resulting RMP throughout the organisation.

Councils' Internal Controls also are integral to the risk management process. Internal Controls exist, in part, to ensure Councils' risks are managed to an acceptable level. Councils' Internal Controls should be monitored, reported and acted upon in a timely fashion to support mitigation of identified risks. Please see Financial Sustainability Information Paper 21: *'Internal Financial Controls'* for more discussion on this topic.

Monitor and Review

A Council's risk management process is not designed to be a one-off procedure but rather a part of ongoing business. A Council and its management team must have in place locally appropriate plans, policies and arrangements to manage and mitigate the organisation's business risks. A Council's Audit Committee has responsibility for reviewing the adequacy of these plans, policies and arrangements. Regular reporting and review against key criteria will ensure that treatment plans, if any, are achieving their aim and remain relevant. It will also serve to highlight changes in risk ratings, and identify any new risks, arising from changing business circumstances.

Recording

Councils should ensure that their risk management systems are supported by a structured process to record relevant information including: risks identified, mitigating influences and controls, analyses and assessments, treatment options and methodologies, decision processes and treatment performance results. Good corporate governance dictates that risk management information is captured and retained throughout the risk management cycle.

Issues for Councils

The management of risks is key to Councils' achievement of ongoing strategic and operational objectives including financial sustainability.

Councils should develop and adopt an organisation-wide Risk Management Framework which includes RMPs that have been developed in a systematic manner through a sound risk management process. The process outlined in this paper is based on the Australian Standard AS/NZS 4360:2004 Risk Management and presents an appropriate methodology for Councils to use. Councils should also adopt ongoing procedures to monitor, review and update these plans to ensure that they maintain currency and appropriate focus.

It is important however to emphasise that the adoption of a RMP will not lead to the elimination of risks but, rather, to the management of these risks in a cost-effective and strategic manner that supports good governance principles.

Acknowledgements

The contribution of Mark Jeffreson of UHY Haines Norton in the preparation of this paper is acknowledged.

The development of this information paper has been assisted by funding from the Local Government Research and Development Scheme.

Risk Management Example - Procurement

The Director of Corporate Services ("DCS") of a Council is aware of a suspected failure of the operation of delegations within the Council's procurement system. Specifically, there is documented evidence that a site manager has contracted with an external supplier for maintenance works to be performed on a Council-owned facility above his procurement delegated authority and has inappropriately engaged a corporate entity associated with the Council.

The DCS is aware of other instances of suspected poor procurement practice, and so has identified the inherent risk of 'Inappropriate procurement of contracted services to Council'.

The DCS undertakes an analysis of the risk and concludes that the likelihood of occurrence is 'Almost Certain' since the evidence at hand indicates a history of poor procurement practice. The DCS also determines that the consequence rating of the risk is 'Moderate', given the potential damage to public relations should the identified breaches become known outside Council, and the potential financial detriment to Council of due process not being followed for the activity.

The next step for the DCS is to evaluate the inherent risk. In this instance, given the sensitivity of the matter and not wishing to unnecessarily alarm staff members, an external risk management specialist is engaged to conduct a review of Council's procurement system and affected staff are informed that the exercise will be conducted and assured it does not constitute a 'witch hunt'.

The review reveals a number of potential causes of the risk identified, and the ineffective operation of the controls it has in place to ensure compliance with Council's procurement policy. The controls and mitigating factors associated with the risk are concluded to be 'just satisfactory'.

An example of how an internal auditor, responsible person or external consultant might document their approach to risk evaluation in the context of procurement is at Attachment B.

In light of the above, the DCS determines that the residual risk requires preparation, active review and management of treatment options on the basis that the inherent risk is very high and the controls and mitigating factors are inadequate. The DCS initiates the development of a treatment plan, and engages the assistance of the financial controller and the risk management officer to do this.

The treatment plan is drafted, submitted for approval and put into action. The Internal Audit Committee (or officer) is informed of the measure, and adapts its compliance procedures accordingly. The process, including a narrative, the report of the consultants and the treatment plan are documented and filed appropriately. Internal audit agrees to report its periodic review of the operation of the treatment plan to the DCS and general management to respond to and action accordingly.

This example demonstrates the practical steps and procedures that might be undertaken by a Council in response to the identification of a specific risk. It should be noted that communication and consultation with stakeholders occurs throughout and that there is also a monitoring and review process implemented (including recording of the exercise from beginning to end).

Attachment B

Procurement Risk Evaluation

Risk	Cause	Control	Likelihood	Consequence	Inherent Risk	Control	Residual Risk
Inappropriate procurement of contracted services to Council	Lack of policy, procedure or practice	Policy/procedure/practice document exists and has been formally adopted by Council.	Rare	Critical	High	Satisfactory (Inadequate)	Very High
	Inappropriate delegations	Delegations are approved at the appropriate level and reviewed periodically	Possible	Serious	Very High	Good (Adequate)	High
	Deficient enforcement of delegations	Exercise of internal delegations is governed, for example: <ul style="list-style-type: none"> • Electronically (passwords, log-ons, access codes) • Physically (keys, locations, computer hardware) • Governance (authorisation, endorsement, dual signatories) 	Likely	Moderate	High	Poor (Inadequate)	Very High
	Goods/services are not fit for purpose	Provisions of policy/procedure/practice document include appropriate direction on the acquisition of suitable goods/services and are adhered to	Almost Certain	Moderate	Very High	Satisfactory (Inadequate)	Very High
	Council receives poor value for money	Provisions of policy/procedure/practice document include appropriate direction on achieving economies of expenditure and are adhered to	Almost Certain	Moderate	Very High	Satisfactory (Inadequate)	Very High
	Overall			Almost Certain	Moderate	Very High	Inadequate