OPERATIONAL RISK MANAGEMENT: AN IMPLICATION IN LEASING BUSINESS

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ABSTRACT

This study also includes risk management and tools to protect all levels of risk efficiently and effectively in order to achieve organization's business goal and to sustain long term business growth. The leasing business tends to expand aggressively and the business operation itself has included various functions, each of which usually involves revenue and expenditure cycles. Such processes are highly subject to possible losses or damages from various reasons such as relaxed working process, the carelessness of employees and fraudulent intention. We select qualitative approach to assess risk. The probability of the risk impact of leasing business range, from 1 to 8 points of scale (which normal used in leasing business in Thailand) and risk impact level (or the magnitude) of each activity from the low to high. The results of risk analysis and assessment will be as a part of an internal audit plan and procedures in order to focus the audit and resources management in all significant activity areas which can pose high risk. Internal control can filter or lessen the risk that can cause damages in organization.This will add in auditing report and being acceptable to management.

Background and its significance

Risk is the level of exposure to uncertainties that can cause disaster or failure both publicly and personally. Risk, in this case, consists of 3 components: event, situation and the loss that can occur. (Institute of Internal Auditor (IIA), 2538)

After the risk components have been realized, the impact towards business objectives of an organization in all levels must be followed. Since all risks can be controllable and uncontrollable, risk analysis and assessment have been given the most attention. This study also includes risk management and tools to protect all levels of risk efficiently and effectively in order to achieve organization's business goal and to sustain long term business growth.

Business risk can be categorized as followed:

1. Liquidity risk, which occurs from the mismatch between funding, sourced and used. Risk management can be performed with an emergency backup plan.

2. Market risk, which occurs from a price fluctuation, and damage the organization. Risk management in this area has been rapidly developed such as the development of derivatives. Currently, risk management has been broadly focused in risk measurement in related to business risk.

3. Credit risk, which normally occurs when a business counterpart can't perform as contractually, agreed. The risk will be high in the case of debt concentration. The risk can be categorized as expected and unexpected risk. The expected risk can be predicted and set for a reserve. On the other hand, unexpected

risk occurs from the failure of system by considering the capital adequacy and search for risk management tools.

4. Operational risk can be divided into internal and external risk. Internal risk can occur from the failure of operational process within organization. The significant factors are personnel, process and information technology. The examples of internal risk management are human resource management, proper compensation and standard working procedures. The external risks are the strategic risk in a systematic planning which may not be proper under the changing environment such as tax and legal. The example of external risk management is the strategy planning.

5. The business continuity risk which can be a catastrophic loss to a company. Risk management must have a contingency plan such as backup file for computer system.

Risk Measurement Methods

We consider the significance and likelihood of the any event or risk factor. The likelihood or probability of the event is an important tool to the future development of risk assessment and analysis.The popular processes are as followed:

1. Qualitative measurement

Employing the principle of Expected Loss (risk) function is the way to estimate the loss or risk exposure by multiplying total probabilities of loss or risk exposure by an asset value or the impact level of each risk factor.

Risk measurement and prioritization are the most significant part of risk assessment, which can be ranging from the means value, weight average value or applying mathematical and statistical formulas. And the analysis result is usually in ranking numbers or in table of analysis such as matrix ranking developed by Jerry Fitz Gerald. The analysis will conceive both the impact and the likelihood of risk factor as shown below:

	H	M	H	H	
Impact	M	L	M	H	
	L	L	L	M	
		L	M	H	Possibility

Figure 1 illustrate the assessment of risk ranking

H = High Likelihood of the event which can cause serious impact

M = Medium Likelihood of event which can cause moderate impact

L = Low Likelihood of event which can pose insignificant impact

The impact can be considered for both financial and non-financial aspects i.e.the impact on financials, the business reputation, the morale support, business process and the loss distribution. Each level of any impact can be directly scored with a weight average such as 1-10 or 1-3 represent the low-high level of risk or scored as the alphabet such as H = high risk, M = medium risk, L = low risk.

On the other hand, likelihood of event (probability) can be considered from internal control system, technology complexity, management reliability and creditability, efficiency and effectiveness of involved personnel, the weakness found during an audit, the follow-up period from the last audit. The event likelihood can also be scored with a weight average or in alphabet.

2. Quantitative measurement

The most popular quantitative measurement is Value-at-Risk (VaR), which is widely used in financial risk such as credit, interest, foreign exchange and security. The measurement has predetermined the potential loss under the possible future time horizon with certain probabilities. This can be set in formula as below:

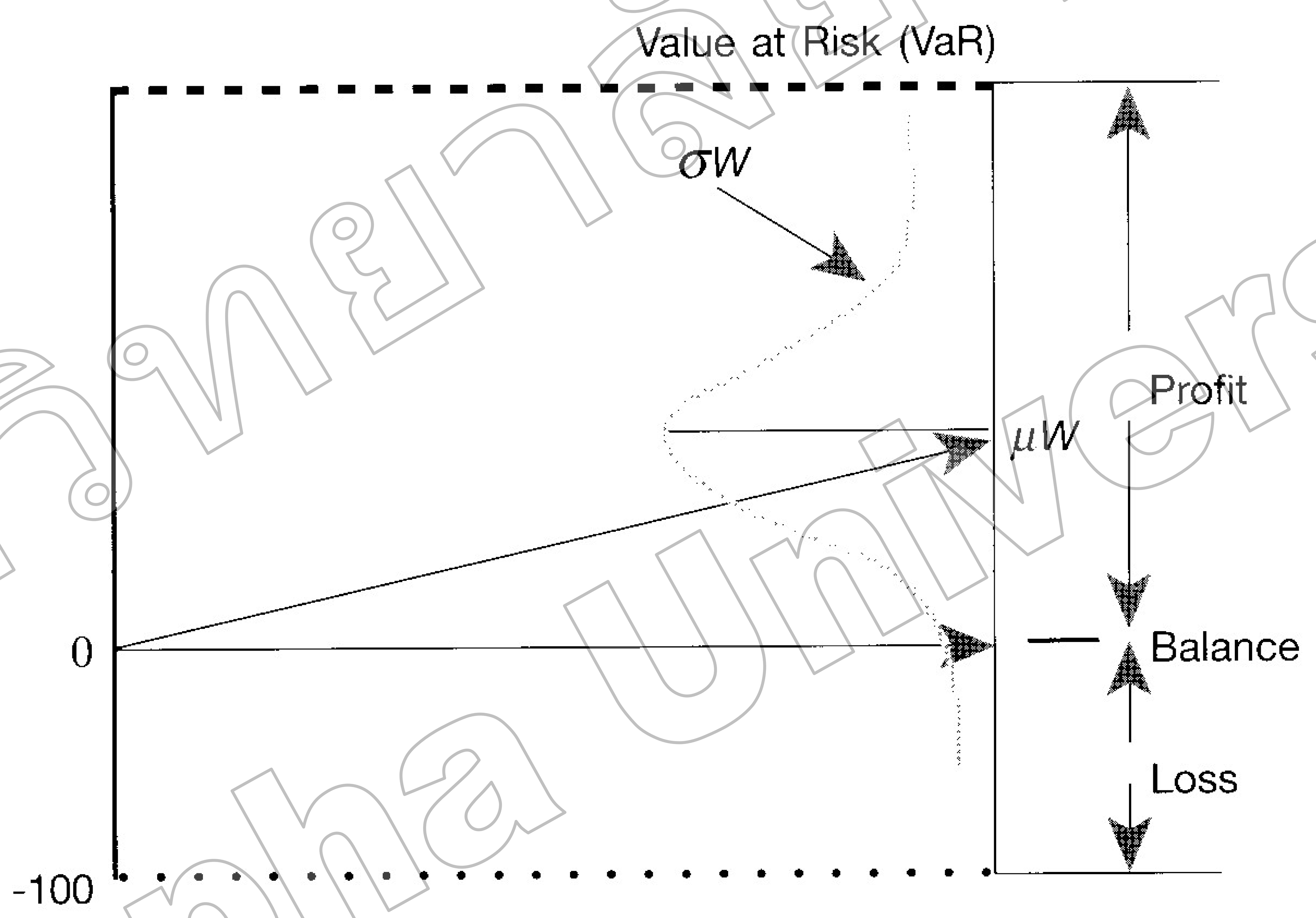


Figure 2 Value-at Risk Diagram

$$VaR = \mu W - Z_{\alpha} W$$

μ represents the average return received

Z_{α} represents the level of confidence or the tolerance level of loss

W represents weight average or the investment value

represents the standard deviation of the return

VaR is
1. The highest possible loss
2. Under a given level of confidence
3. The level of probability
4. For a period of investment

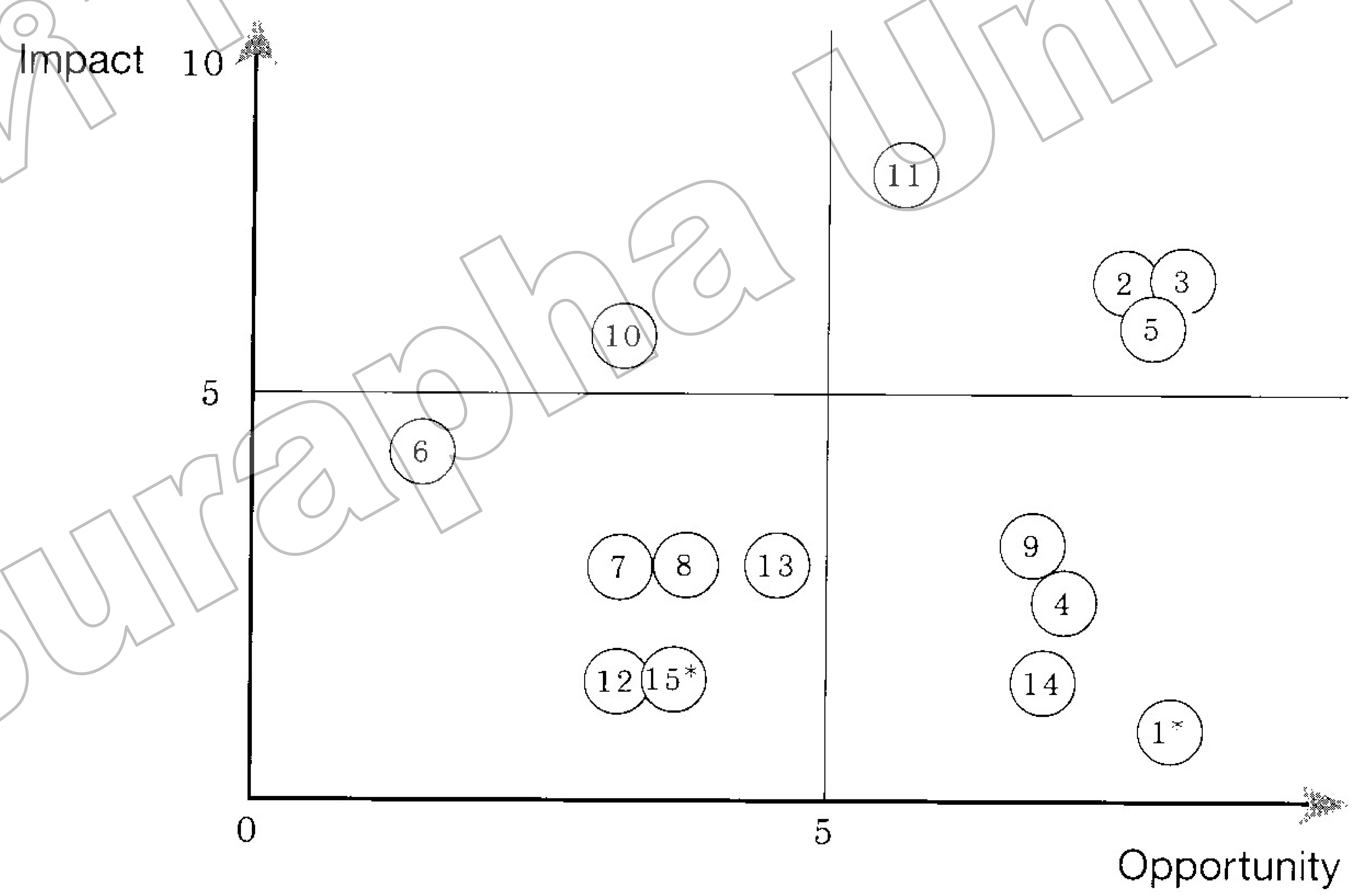
An Implication in Leasing Business.

Leasing is the financing business to provide capital asset the company needs in production and operation by leasing the asset instead of buying. Lessee has to select, look for and negotiate the price of asset with distributors or direct manufacturer by himself. The lessee will then find a funding source to purchase the assets or find the lessor, which is normally the leasing company. When the company agrees with the leasing company, the leasing company will then purchase such asset and then charge the leasing expense from lessee in accordance with an asset cost and time period of leasing contract. Mostly, the leasing contract will set the time period for at least 3 years.

The car leasing business tends to expand aggressively. The business operation itself has included various functions, each of which usually involves revenue and expenditure cycles. Such processes are highly subject to possible losses or damages from various reasons such as relaxed working process, the carelessness of employees and fraudulent intention. The company has not only been damaged, but also negatively impacted in term of the creditability. The more frequently the company has suffered from great loss, the less stable and reliable the company is in the public's eyes.

To protect company from any possible loss, management and internal auditor in car leasing company must be conscious of any attempt to create working process suitable for quantities of work. Thus, the importance of internal audit to support management's decision must be realized so that management will be aware of the weakness in any business working process that can be threatening to the company's loss.

Risk assessment



Note: *Risk Factors in Business

Figure 3 the impact of risk to organization

The relation between risk and internal control. Internal control can filter or lessen the risk that can cause damages in organization. However, creating internal control system to protect all possible business errors, can be difficult and excessive. Thus, proper internal control encourages effective operation.

Organizational structure and working process in leasing business

Marketing

1. Select qualified and proper car dealers
2. Contact customer who is interested to lease
3. Check customer's credit

Credit control

Authorized personnel

Analyze customer's credit for approval

Consider and give opinion by authorized level

Credit administration

1. Prepare contract and request for identification document
2. Collect premium and installment checks in advance
3. Notify car dealers to release the car

Finance

Pay for investment, commission, discounted insurance premium to car dealers

Collection

Collect installment payment from due customer

Credit Administration

Contact customer and service to transfer the ownership registration to customer when he or she has fully paid all installments

overdue two consecutive installments

Legal and collection

1. Contact and negotiate with customer to pay overdue installment with late charge
2. If customer still hasn't paid, we will proceed for legal action

Figure 4 Diagram illustrate leasing procedure

Risk measurement

Risk measurement can be performed in various ways such as expected loss (risk) function, weight matrix and Value-at-Risk (VaR). In this case, we select qualitative approach to assess risk by following formula:

$$\text{Expected loss (risk)} = \sum_{i=1}^{N} P_i V_i$$

P_i = Probability of an event expected to occur ranging from 1 to 8 points of scale.

V_i = The level of impact from risk factor (RF) in each activity which can be grouped into 3 levels*.

Note:*

1. the impact towards RF is very low
2. the impact towards RF is moderate
3. the impact towards RF is very high

Risk measurement and assessment table

Risks	Risk factors																
	RF_1			RF_2			RF_3			RF_4			RF_5			RF	Average
	V	P	T	V	P	T	V	P	T	V	P	T	V	P	T	total	(%)
1. Customer credit approval has important risks as follows	3	7	21	1	5	5	3	8	24	3	7	21	3	6	18	89	20
2. Contract preparation has many important risk as follows	3	5	15	1	4	4	3	6	18	3	6	18	3	7	21	76	17
3. The payment procedure to car dealer has important risk as follows	3	3	9	3	6	18	2	5	10	3	3	9	3	3	9	55	12
4. Asset insurance procedure has important risks as follows	2	6	12	1	3	3	3	4	12	2	5	10	2	5	10	47	11
5. Installment collection procedure has important risks as follows	3	8	24	3	8	24	3	7	21	3	8	24	3	8	24	117	27
6. Closing account procedure	1	1	1	1	2	2	1	1	1	1	1	1	1	2	2	7	2
7. Legal procedure	1	2	2	2	1	2	1	2	2	1	2	2	1	1	1	9	2
	Total															**441**	**100**

The business risk is inherent from both internal and external factors of organization, especially the lack of risk management and a reliable and effective internal control. Since business risk is critical to a success or failure on organization, it is essential for management to assess whether risk exists and lingers in certain activities in order to design a proper measure to control or minimize risk to an acceptable level. The risk analysis and assessment are still an important audit technique to assist auditor in audit planning and testing for all relevant activities. This can also help auditor in managing time and resources for a more important content.

Because the objective of this research is to perform a study on risk analysis and internal audit guidelines to minimize risk in car leasing business which can be divided into 3 main areas as followed:

1. Organizational structure and working procedures
2. Risk analysis and internal control system
3. Internal audit guidelines in leasing business

Risk management approach and internal control guidelines

Working procedures and business processes are subject to different level of risks. Certain business risks are inherent in working process itself while other risks on the other hand are derived from the process owners themselves in breaking or breaching the company's policy and procedure. Even though working rules do exist in the organization, business risks are usually involved in revenue assurance such as overvalued car, the completeness and accuracy of leasing contract and collateral, check payment control, frauds on installment payment of customer, incomplete revenue collection, confiscated assets with a fraudulent intention and stolen asset and other car equipment installed. To analyze and assess risk in high-risk areas can be discovered in collection procedure, customer credit approval procedure and contract preparation.

A proper internal control system should aim at duty segregation and task delegation to organizational employee. Organization structure is critical to a proper task allocation and segregation with a clear responsibility and authorized limit area for all employees in every part of business. The organization structure must encourage control in documentation and liquid assets. If employee has well performed his or her duties, his work will be automatically proved another employee's work.

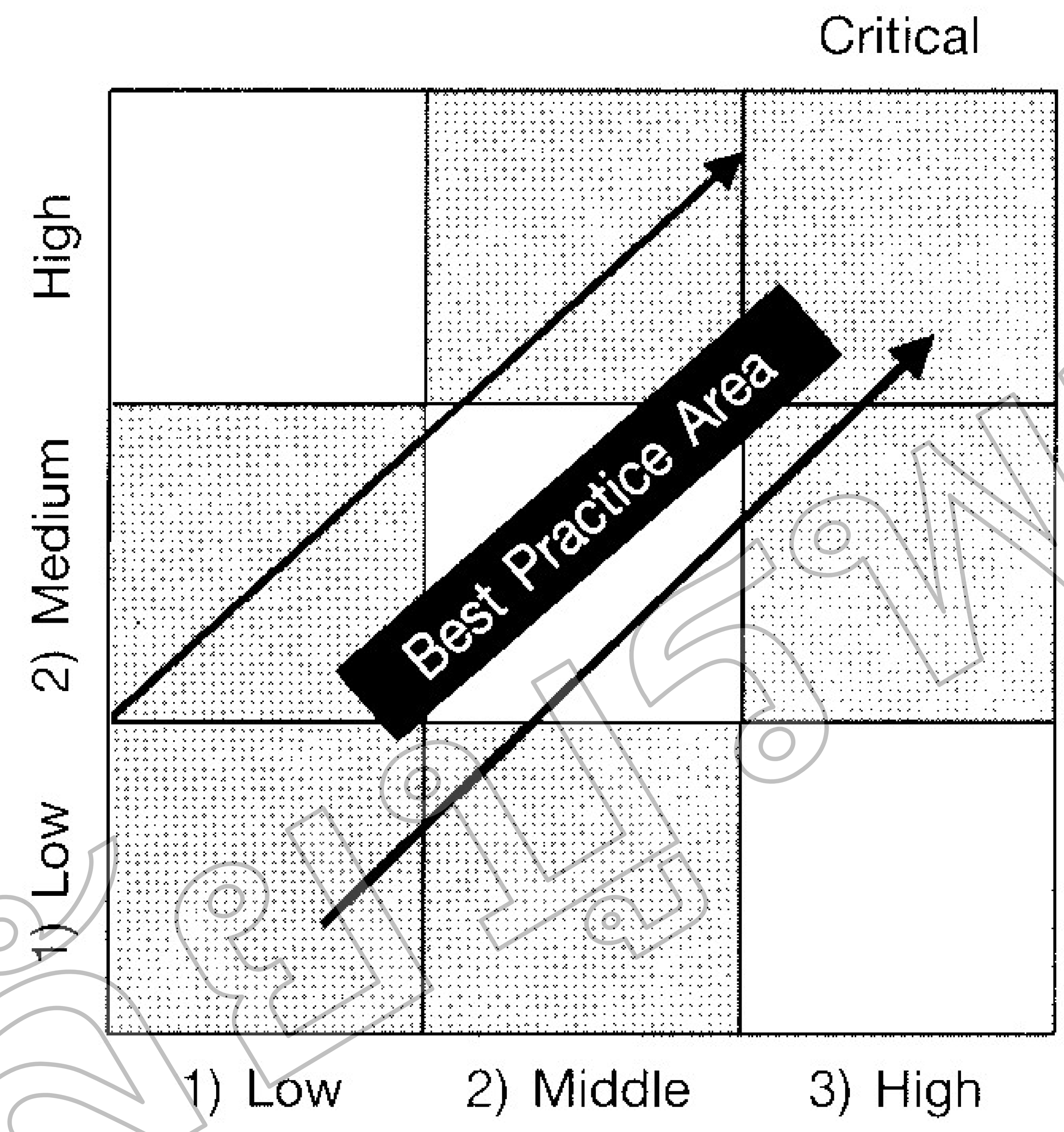
Internal audit guidelines in leasing business

Significant internal audit standards must specify risk analysis and assessment as a part of an internal audit plan and procedures in order to focus the audit and resources management in all significant activity areas which can pose high risk. This will add in auditing report and being acceptable to management.

Best Practice Operation

Risk Level
1) Low
2) Middle
3) High

Control Level
Lowest (1) to
Highest (3)



Source: Enterprise-wide Risk Management : Strategies for linking risk and opportunity

Recommendations

1. Effective risk analysis and assessment. Assessor must coordinate with executive management to understand all relevant issues and at the same time improve risk analysis and assessment used in order to correspond with existing guidelines of an organization.

2. Assessor must comprehend thoroughly to leasing business and its operation. This can positively produce a more reliable and acceptable outcome to management, to assessor or even to employees who are being audited.

3. The most difficult part in risk analysis and assessment is the business ethic analysis of management and process owners in various levels and to see if it is acceptable. Therefore, if organization has a chance to improve employee's ethics in many levels, risks should be reduced.

4. Management or executive management should support internal auditors to perform independently and extensively without any interference and to encourage them to continue expanding knowledge and capabilities. This can not only help them perform the job as being eyes and ears for management but also increase good corporate governance within an organization.

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