

Of Scenarios and Accountants: The Importance of Scenario Analysis for Organisations



Scenario analysis has an important role to play in risk management. Organisations engage in scenario analysis or use methods or techniques to identify and assess risk to achieve its objectives. This article provides an insight into the significant contributions professional accountants may make towards improving the efficient management of resources, corporate governance, and the facilitation of information, by engaging in scenario analysis exercises. Read on to know more...



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If I tell you it is going to rain tomorrow and you have outdoor plans, I have given you useful information. But I have not yet solved all of your problems: maybe you will only need to pack an umbrella or maybe you need to cancel your plans or move it indoors. In other words, even if you knew a risk event, the possible consequences

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and their likelihoods in advance, you still need to determine how best to respond. This is where scenario analysis comes into play and can help.

Scenario analysis in brief

The International Organisation for Standardisation (ISO)'s 31010: Risk Assessment Techniques standard describes scenario analysis as, *"the development of descriptive models of how the future might turn out."* ISO goes on to say, *scenario analysis "can be used to identify risks by considering possible future developments and exploring their implications. Sets of scenarios reflecting (for example) 'best case', 'worst case', and 'expected case' may be used to analyse potential consequences and their probabilities for each scenario as a form of sensitivity analysis when analysing risk."*

The objectives of scenario analysis vary, but the process is generally:

- Setting an intended *objective* and determining the context (internal and external environment) in which that objective needs to be achieved;
- Determining a limited series of *possible outcomes* and the assumptions underlying the achievement of those outcomes;
- Identifying, analysing, and evaluating *events*—positive (opportunities) or negative (threats)—that may or may not occur, which range from the probable to the highly improbable and might enable or thwart achievement of those outcomes;
- Considering existing *strengths and weaknesses* in an organisation's staff, procedures, and resources to deal with an event or its possible consequences; and
- Determining a series of *supplementary actions* needed to appropriately address the remaining and unwanted risk.

While going through the cause-and-effect sequence of creating a story, our imaginations may identify other variables. When groups of individuals engage in this exercise together, the number of newly detected variables increases. As a simple example, a group of business executives, each representing

specific functions within an organisation (e.g., sales, marketing, product development, accounting, and human resources), are challenged to imagine the effect of different types of disaster scenarios on their business—a significant hurricane, a terrorist attack, an earthquake, and an health epidemic. Although the parameters of the exercise are the same for everyone, each participant applies his or her imagination as to how these developments could play out.

One participant may note that the primary threat from a hurricane is about flood damage to regional infrastructure, which interrupts the transportation of goods—they may not even consider flood damage for business facilities. Another participant could note that a terrorist attack may not come in the form of bloodshed and physical destruction but instead as cyber-attacks on security and consumer data. Someone who has experience in an area prone to earthquakes may bring to everyone's attention that if the business is not located in an earthquake zone where preparedness is commonplace, the implications could be even more chaotic and long term. Another participant could call attention to the possibility that a health epidemic may not be a gruesome plague like in a movie but, rather, a really bad strain of flu that strikes a high percentage the population. For each participant in such an exercise, there are at least as many nuanced perspectives on what could happen, resulting in more descriptive scenarios to consider.

Participants are also likely to assess the impact of these types of events in respect to their own objectives for the company. An individual from the accounting department will most likely be focused on managing financial risks while an individual from human resources will likely be focused on contingency plans for staff. Collectively, the views of participants contribute to developing a more inclusive set of scenarios, and create better plans to prevent events from happening and deal with consequences.

Scenario analysis and professional accountants

What ways can professional accountants provide unique contributions to scenario analysis exercises? As we are typically involved in the information provision processes of organisations, we can facilitate effective scenario analysis by providing participants

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with high-quality information, including explicit understanding of related risks and their potential consequences. Accountants can use scenario analysis to improve the efficient management of resources, corporate governance, and the facilitation of information.

To help facilitate efficient management of resources, accountants can provide cost/benefit analysis to assess potential impacts of scenarios. We can also plan for the movement or re-allocation of capital and other resources necessary to implement the measures deemed necessary based on the outcomes of the scenario analysis exercises. We are also able to plan for capital and other reserves to create sufficient resilience for dealing with certain events.

On the risk and governance front, we can advise on the possible responses that leave organisations vulnerable and recommend establishing internal controls, and the most appropriate internal controls for the organisation. We can also

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suggest improvements for corporate governance arrangements to change behavior and organisational procedures.

What is your experience with scenario planning?

Scenario analysis has an important role to play in risk management. Has your organisation engaged in some form of scenario analysis or does it use other methods or techniques to identify and assess risk to achieving your organisation's objectives? ■

(This article originally appeared on the IFAC Global Knowledge Gateway: www.ifac.org/Gateway. Visit the Gateway to find additional content on a variety of topics related to the accountancy profession.)

