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Business Brief
From the Business, Industry & Government Team

The Perils and Promises of Integrated Enterprise Risk and Performance Management

Among businesses, there is increasing interest in the integration of enterprise risk management and enterprise performance management, but there is confusion and lack of consensus about what each of them is, let alone how to integrate them. Finding the best way to apply meaningful measurements adds to the problem. But most disturbing is recent research that shows that, however interested in enterprise risk management and enterprise performance management they may be, executives are not adequately funding these functions, possibly due to fears that it will reduce profits. In addition, they are not allowing risk managers — or those whose role it is to coordinate risk — a seat at the executive table. Risk managers do play a valuable role within an organization, however, their focus on risk across the enterprise is meant to help mitigate the chance of potential risks and protect the organization's profits.

Enterprise performance management (EPM) is much broader than its previously misperceived narrow definition as simply being dashboards and better financial reporting. EPM is a concept involving integrated methodologies. EPM is a *part* — albeit a crucial, integral part — of how an organization realizes its strategy to maximize its value to stakeholders, both in commercial and public sector organizations. This means that enterprise performance management must be encompassed by a broader overarching concept — enterprise risk-based performance management — that integrates with enterprise risk management (ERM).

The foundation for both ERM and EPM share two beliefs:

1. The less uncertainty there is about the future, the better.
2. If you cannot measure it, you cannot manage it.

Is Risk an Opportunity or Hazard?

ERM is not about minimizing an organization's *risk exposure*. Quite the contrary, it is all about exploiting risk for maximum competitive advantage. Relying on a risky business strategy and plan always carries a high price. For example, when investment analysts are uncertain about a company's prospects, in part due to insufficient information, their inability to approximately predict financial results may lead to an analysis that will increase the firm's financing capital costs, and thus, reduce its stock price.

Effective risk management practices counter these examples by being comprehensive in recognizing and evaluating all potential risks. Its goal is to reduce volatility, create greater predictability, decrease surprises, and, most

importantly, allow for quick recovery after a risk event occurs.

A simple view of risk is that more things *can* happen than will happen. If businesses can devise probabilities of possible outcomes — outcomes that are different from normal expectations — then they can consider creative options for how to deal with surprises and evaluate the consequences of predicting outcomes incorrectly. In short, risk management is about dealing in advance with the consequences of being wrong about a business decision. But, as much as risks are potential hazards, they are also opportunities that can prove beneficial. For example, a rain shower may be a disaster for the county fair but creates a boon for an umbrella salesperson. Risk and opportunity are concerned with future events that may or may not happen; the events can be identified, but the magnitude of their effect uncertain. However, the outcome of the events can be influenced with preparation, in the form of ERM.

Problems Quantifying Risk and its Consequences

Because of its potential for introducing new problems, risk is usually associated with new costs. In contrast, opportunity may lead to benefits such as new economic value creation and increased revenues. Most organizations cannot quantify their *risk exposure* — the potential for being affected by risk — and have no common basis to evaluate their *risk appetite*, or the amount of risk they are willing to absorb to generate the expected returns, relative to that exposure. The objective with ERM is not to eliminate all risk, but rather to match risk exposure to risk appetite.

Not to be confused with merely contingency planning, ERM begins with a systematic method of recognizing sources of uncertainty. It then applies quantitative methods to measure and assess three factors:

1. The probability of an event occurring
2. The event's severity of impact
3. Management's capability and effectiveness to respond to the event

Based on these factors, ERM identifies the triggers and drivers of risk (key risk indicators, or KRIs), and then it evaluates alternative actions and associated costs to potentially mitigate or take advantage of each identified risk. These should ideally be included during the strategy formulation and re-planning processes as well as reflected through financial projection scenarios, which are commonly called a "what if" analysis.

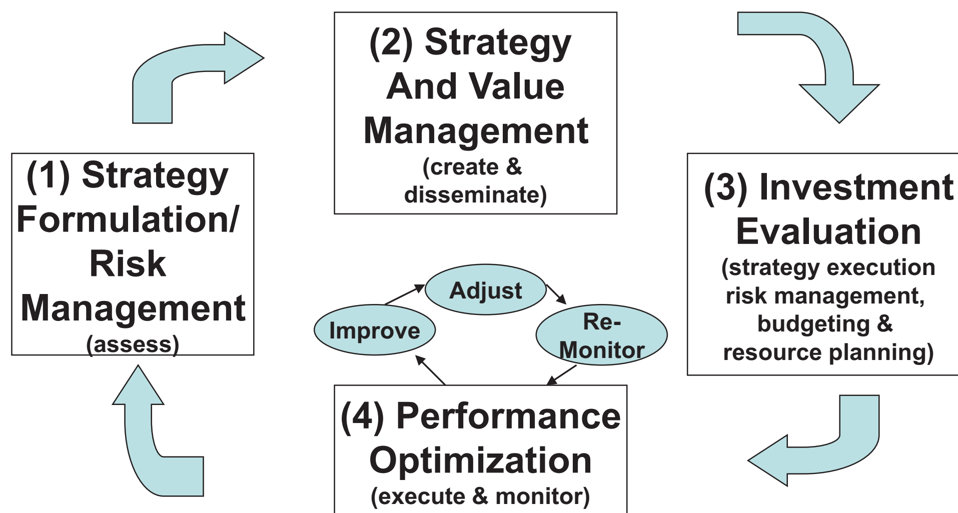
Multiple scenarios based on estimated probabilities of multiple variables are the accepted approach to glean impact sensitivities and to determine which risk mitigation actions to pursue or reject. Using probabilistic scenarios provides strategists with distributions of possible outcomes and their source cause. Scenario analysis combines good business judgment with fact-based business analytics. Trend analysis, regression and correlation analysis are involved, but they no longer need to be scary memories of a university statistics course. Today, analytical software is designed for even the most casual user.

Risk-Based Performance Management Framework

The premise behind risk-based performance management framework is to link risk performance to business performance. Whether defined narrowly or more broadly, performance management does not currently embrace risk governance. It should. Risk and uncertainty are too critical and influential to omit. For example, reputational risk caused by fraud (e.g., Tyco International), a terrifying product-related incident (e.g., Tylenol), or some other headline-grabbing event can substantially damage a company's market value.

Figure 1 illustrates how strategy formulation and its execution — risk management plus performance management — combine to achieve the ultimate mission of any organization: to maximize stakeholder value. The risk-based performance management framework four step sequence includes direction setting from the executive leadership —"Where do we want to go?"— as well as the use of a compass and navigation to answer the questions "How will we get there?" and "How well are we doing trying to get there?"

Figure 1: Risk-Based Performance Management



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Step 1: Strategy Formulation/Risk Management. In Step 1 the executives stand back and assess the key value drivers of their market and environment, a process that includes identifying KRIs, which is essential to understanding the root causes of risk. Identifying KRIs is a predictive process; the organization can react before a future event occurs, by continuously monitoring variances between expected and re-forecasted KRIs.

Step 2: Strategy and Value Management. A key component of performance management is formulated in Step 2: the organization's vision, mission and strategy map. Here the executives determine markets, products and customers to target. The vision, mission and strategy map is how the executive team both communicates to and also involves its managers and staff. The organization then collectively identifies the vital few and manageable projects and selects the core processes at which to excel.

Step 3: Investment Evaluation. A plan is one thing, but budgeting for how much to spend in order to accomplish the plan is another. The amount of investment is determined in Step 3 and making that determination involves *strategy execution*. Today's capital markets understand that customer value and shareholder value are not equivalent, nor are they positively correlated, but rather they have trade-offs with an optimum balance that companies strive to attain. This is why the annual budget and the inevitable rolling spending forecasts, typically disconnected from the executive team's strategy, must be linked to the strategy.

Step 4: Performance Optimization. In Step 4, all of the execution components of the performance management portfolio of methodologies kick into gear. These include, but are not limited to: customer relation management (CRM), enterprise resource planning (ERP), supply chain management, activity-based costing and Six Sigma/lean management initiatives. Since the organization will have already identified its mission-critical projects and select core processes in Step 3, balanced scorecard and dashboards — with their predefined KPIs — become the feedback mechanisms to steer the organization in Step 4 (for more in balanced scorecards and dashboards, see next page). The balanced scorecard includes target-versus-actual KPI variance dashboard measures with drill-down analysis and color-coded alert signals. The clockwise internal steps illustrated in Figure 1, — "Improve, Adjust, Re-Monitor" — are how employees collaborate to continuously re-align their work efforts, priorities, and resources to attain the strategic objectives defined in Step 2.

The four steps are a continuous cycle where risk is dynamically re-assessed and the organization's strategy subsequently adjusted.

Risk Managers: Friend or Foe of Profit Growth?
Are risk managers supportive of long-term profit growth, or do they present obstacles that might stifle it? Unfortunately this topic has recently taken a dark edge. A recent report of The Economist Intelligence Unit sponsored by The ACE Group,[1] a global insurance company, and KPMG is titled, "Fall guys: Risk management in the front line." In the report, a risk manager claims he was fired for telling his company's board of directors that the organization was taking on too much risk. Did management want to ignore a red flag of caution to pursue higher profits? This involves whether strategy planners view risk managers as profit optimizers or detractors.

The Economist report was a result of extensive surveys and interviews and the impact of the recent global financial sector meltdown was clearly top of mind for the respondents. The report highlighted that risk management and governance policies and structures require increased authority, visibility and independence. However, planned increases in investment and spending for them are modest or nonexistent. Not a good sign. The reality is that the natural tension and conflict between the risk functions and the business' aspirations for higher profit growth remains present. Key findings of the report are:

- **Strategic risk management is in a relatively embryonic stage.** Executives view the identification of new and emerging risks as a key objective of risk management, but roughly two-thirds of them believe their organization is weak at anticipating and measuring future risks.
- **Few organizations involve risk functions in key business decisions.** Few companies expect risk functions to participate in strategic decision making in the near future.
- **Risk management should shift its emphasis from preventative activities to proactive and supporting ones.** Risk managers should expand beyond police-like controls and monitoring to also include identifying opportunities in order to achieve business objectives.

Invulnerable Today but Aimless Tomorrow
Will increasing interest in including the risk function in strategy formulation continue or be a temporary phase? Hopefully, the interest will be permanent, but there are impediments. Business line managers may continue to view the risk function as a mechanical brake slowing sales and profit growth. Also, technical knowledge and experience by boards of directors and executives may be inadequate to fully understand how to integrate enterprise risk and performance management.

On a positive note, risk management is gaining influence and businesses are using more

[1] http://www.businessresearch.eiu.com/fall-guys.html

structured modeling and analytics software to get a handle on it. Managers are creating a richer organizational culture for metrics and risk awareness that considers opportunities, not just threats.

Is the risk manager going to continue to be the fall guy? Not if those responsible for strategic planning appreciate that they are not gamblers using investors' money, but rather stewards of the company's — and investors' — financial futures.

About the Author

Gary Cokins is a manager of global business advisory services involved with performance management solutions with SAS, a leading provider of performance management and business analytics software headquartered in Cary, North Carolina. Mr. Cokins is a speaker and author of many books, including: *Activity Based Cost Management: Making it Work*; *Performance Management: Finding the Missing Pieces to Close the Intelligence Gap*; and *Performance Management: Integrating Strategy Execution, Methodologies, Risk, and Analytics*. He serves with Professor Robert S. Kaplan on the International Monetary Fund's activity-based costing advisory panel as well as on the board of advisors of www.kpilibrary.com, www.smartdatacollective.com, http://bigfatfinanceblog.com, and www.information-management.com, posting articles on each site regularly. He can be reached at gary.cokins@sas.com and you can read his blog at http://blogs.sas.com/cokins.

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AICPA Resources
Enterprise Risk Management
www.aicpa.org/ERM

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Enterprise Risk Management
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What's the Difference Between a Scorecard and a Dashboard? And a KPI and a PI?

Scorecards and dashboards provide strategic and operational performance feedback so that every day, every employee can answer the fundamental question, "How am I doing on what is important?" Organizations regularly identify hundreds of key performance indicators (KPIs), yet they all cannot be classified as "Ks." This begs knowing what the differences are between strategic KPIs that are displayed in scorecards and operational performance indicators (PIs) that are displayed in dashboards. Both types are important measures, but they serve different purposes. Scorecard KPIs periodically monitor the progress toward accomplishing the cause- and effect-linked strategic objectives visually displayed in the executive team's strategy map. KPIs have dependencies. In contrast, dashboard PIs measure processes and outputs at more frequent intervals, possibly near real-time, and they are typically in isolation of other measures.

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