Analytics-Based Performance Management LLC
401 Hogans Valley Way, Cary, NC 27513
www.garycokins.com

Partners or Rivals? Risk Managers and Strategy Planners

By Gary Cokins, CPIM
Founder of Analytics-Based Performance Management LLC

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There is increasing interest in the integration of enterprise risk management (ERM) and enterprise performance management but there is also confusion and a lack of consensus about what each of them are, let alone how to integrate them. Applying meaningful measurements adds to the problem. Perhaps most disturbing is that despite the interest, executives are not adequately funding the risk management function, possibly due to fears that it will reduce profits. In addition, the C-Suite in many cases is still not allowing risk managers a seat at the executive table.

Governance and compliance awareness are clearly on the minds of executives. Accountability and responsibility can no longer be evaded thanks to an on-going influx of regulatory compliance requirements this century. If executives err on weak compliance, they can go to jail. As a result, internal audit controls have been beefed up. The popular acronym that addresses this is GRC for governance, risk, and compliance. From the perspective of enterprise performance management, one can consider governance (G) as the stewardship of executives to behave in a responsible way, such as providing a safe work environment or formulating an effective strategy; and consider compliance (C) as operating under laws and regulations. Risk management (R), the third element of GRC, is the element most associated with enterprise performance management.

Enterprise performance management is now more correctly being defined as a much broader umbrella concept of integrated methodologies – much broader than its previously misperceived narrow definition as simply being dashboards and better financial reporting. What could possibly be an even broader definition? My belief is enterprise performance management is only part – but 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 ERM.

The “R” in GRC has similar characteristics of enterprise performance management. The foundation for both ERM and enterprise performance management 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. A risky business strategy and plan always carries high prices. For example, what investment analysts do not know about a company or they have uncertainty or concerns will result in adding a premium to capital costs and discounting of a company’s stock value. Uncertainty can include accuracy, completeness, compliance, and timeliness in addition to just being a prediction or estimate that can be applied to a target, baseline, historical actual (or average), or benchmark.

Effective risk management practices counter these examples by being comprehensive in recognizing and evaluating all potential risks. Its goal is less volatility, greater predictability, fewer surprises, and arguably most important the ability to bounce back quickly after a risk event occurs.

A simple view of risk is that more things can happen than will happen. If we can devise probabilities of possible outcomes, then we can consider how we will deal with surprises – outcomes that are different from what we expect. We can evaluate the consequences of being wrong in our expectations. In short, risk management is about dealing in advance with the consequences of being wrong. Risk can be viewed as having an opportunity that can be beneficial in the future in addition to risk viewed as a hazard. For example, a rain shower may be a disaster for artists at an outdoor art fair while being a huge break for an umbrella salesperson. What risk and opportunity both have in common is they are concerned with future events that may or may not happen, their events can be identified but the magnitude of their effect uncertain, and the outcome of the event can be influenced with actions.

Problems quantifying risk and its consequences

Risk is usually associated with new costs because they may turn into problems. In contrast, opportunity can be associated with new economic value creation, such as increased revenues, because they may turn into benefits.

Most organizations cannot quantify their *risk exposure* and have no common basis to evaluate their *risk appetite* relative to their risk exposure. Risk appetite is the amount of risk an organization is willing to absorb to generate the returns it expects to gain. The objective is not to eliminate all risk, but rather to match risk exposure to risk appetite.

ERM is not simply contingency planning. That is too vague. It begins with a systematic way 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 severity impact of the event
3. Management's capability and effectiveness to respond to the event

Based on these factors for various risks, risk management identifies the triggers and drivers of risk known as key risk indicators (KRIs), and then 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 process, and reflected in financial projection scenarios – commonly called "what if" analysis.

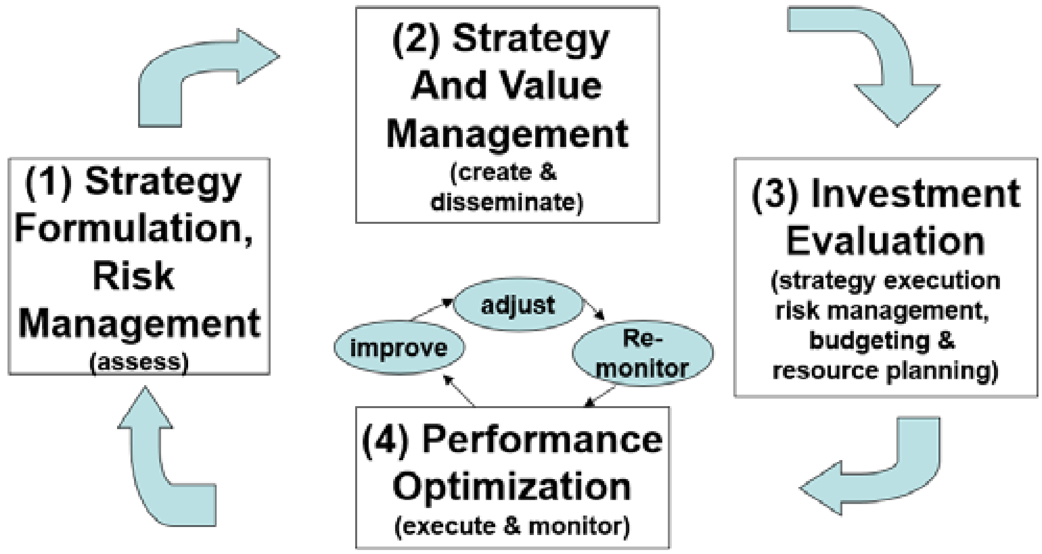
Multiple scenarios based on estimated probabilities of multiple variables (e.g., of occurrence) are the accepted approach to glean impact sensitivities and to determine which risk mitigation actions to pursue or to risk rejecting. Using probabilistic scenarios provides strategists with distributions of possible outcomes and their source cause. It 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 the casual user.

Risk-based Performance Management framework

The premise here is to link risk performance to business performance. As it is popularly described in the media, performance management, whether defined narrowly or ideally more broadly, 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 news 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.

Figure 1. Risk-Based Performance Management:



The 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?"

Step 1. Risk Management. This involves the *strategy formulation* aspect of risk management. Here the executives stand back and assess the key value drivers of their market and environment, a process that includes the identification of their KRIs. Formulating KRIs is essential to understand the root causes of risk. They include a predictive capability, so that by continuously monitoring variances between expected against re-forecasted KRIs, the organization can react before rather than after a future event occurs.

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

Step 3. Investment Evaluation. A plan is one thing, but how much to spend accomplishing the plan is another. That amount is determined in this step. This involves the *strategy execution* aspect of risk management. Resources, financial or physical, must always be considered as being scarce, so they must be wisely chosen. Today's capital markets understand that customer value and shareholder value are not equivalent and 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 Management. In this last step, 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 mission-critical projects and select core processes an enterprise must do well on will have already been selected in step 3, the balanced scorecard and dashboards, with their predefined key performance indicators (KPIs) and performance indicators (PIs), at this stage becomes the mechanism to steer the organization.

The balanced scorecard includes target-versus-actual KPI variance dashboard measures with drill-down analysis and color-coded alert signals. Scorecards and dashboards provide strategic and operational performance feedback so that every employee, who is now equipped with a line of sight to how he or she helps to achieve the executives' strategy, can daily answer the fundamental question, "How am I doing on what is important?" The clockwise internal steps – "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 strategy subsequently adjusted.

Risk managers – friend or foe to profit growth?

Unfortunately, this topic has taken a dark edge. A report from a few years ago of *The Economist Intelligence Unit* sponsored by ACE, a global insurance company, and KPMG was 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 too much risk was being taken. Did management want to ignore a red flag of caution to pursue higher profits? The broader question involves how strategy planners view risk managers. Are they profit optimizers or detractors?

The Economist report was a result of extensive surveys and interviews. The impact of the global financial sector meltdown last decade 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, if any. 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. How can a balance and compromises be achieved?

Key findings of the report are:

- Strategic risk management is in a relatively embryonic stage of maturity – 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 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 using more structured modeling and analytics software. Managers are creating a richer organizational culture for metrics and risk awareness that considers opportunities, not just threats.

I continue to be intrigued by the fact that almost half of the roughly 25 companies that passed the rigorous tests listed in the once-famous book by Tom Peters and Robert Waterman, *In Search of Excellence*, today either no longer exist, are in bankruptcy, or have performed poorly. What happened in the years since the book was first published in 1982? My theory is that once an organization becomes quite successful, it becomes averse to risk taking. Taking risks, albeit calculated risks, is essential for organizations to change and be innovative.

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.

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Gary Cokins (Cornell University BS industrial engineering/operations research, 1971; Northwestern University Kellogg MBA 1974) is the founder of Analytics-Based Performance Management LLC, an advisory firm located at www.garycokins.com. He began his career in industry with a Fortune 100 company in CFO and operational roles. He then worked 30 years in consulting with Deloitte, KPMG, EDS, and SAS. He is an internationally recognized expert, speaker, and book author in business analytics and enterprise performance management systems. Contact Gary at gcokins@garycokins.com or https://www.linkedin.com/in/garycokins.