Leveraging Performance Management to Support Risk Management

These essays are part of a series, *Controllers' Corner: Two-Minute Essays on Financial Management and Control*, which asks industry thought leaders for their opinions on critical issues facing today's finance organizations.

Companies have invested heavily in performance management systems that measure the success of business activities and give insights into the future. But these systems can do more.

The following essays from our ongoing series, *Controllers' Corner: Two-Minute Essays on Financial Management and Control*, outline some of the ways that the same processes and systems that are used for financial consolidation and financial reporting can help organizations improve their risk management. The authors are industry thought leaders who have extensive backgrounds in finance and accounting, and broad experience advising clients on financial processes and systems.

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Delivering Business Results in the Age of Volatility

Tom Willman, The Hackett Group

The volatility of the current economic environment demands that Finance take a broader, more holistic approach to performance management, including the assessment and management of risk.

Q How should organizations incorporate risk management capabilities into their enterprise performance management processes?

Volatility and uncertainty have reached such levels that the ability to swiftly adjust to changes in the business climate is not only a competitive advantage, but in many industries it is now critical for survival. This capability means being both "proactive in strategy" and driving "excellence in operations." Finance plays a crucial role in this transformation. And Finance needs to elevate its functional focus to develop a holistic enterprise performance management (EPM) capability. Additionally, Finance needs to achieve excellence in operations by creating a scalable operating model that enables agile responses to changes in business conditions. For the purposes of this discussion, we will focus on what it means to be "proactive in strategy."

The recession of 2008-2009 forced many companies to evaluate their true profitability drivers and competitive advantages in a period of dramatic deterioration in the business environment. It forced them into making tough decisions that in many cases were long overdue. However, because the implosion was so sudden and so deep, many organizations ended up having to make across-the-board cuts just to survive, rather than the kinds of changes needed to structurally improve productivity.

On the other hand, companies that anticipated the disruption and had contingency plans in place made their changes more deliberately, resulting in sustainable improvements to their cost structures. Their foresight proved tremendously valuable under the highly volatile and uncertain conditions that materialized.

Many finance organizations simply extrapolate from past experience to predict the future and use the annual budget cycle to set the direction. However, those finance organizations that are more advanced capture real-time data about business conditions, use sophisticated scenario development and modeling techniques to drive periodic forecasts, and have contingency plans in place for various scenarios.

For companies to become proactive in strategy, they need to develop a holistic enterprise performance management capability. Holistic EPM has three dimensions:

1. EPM should cover financial, operational and strategic aspects of performance
2. The scope of EPM needs to include performance, opportunity and risk management
3. EPM is implemented as an integrated, closed-loop performance cycle

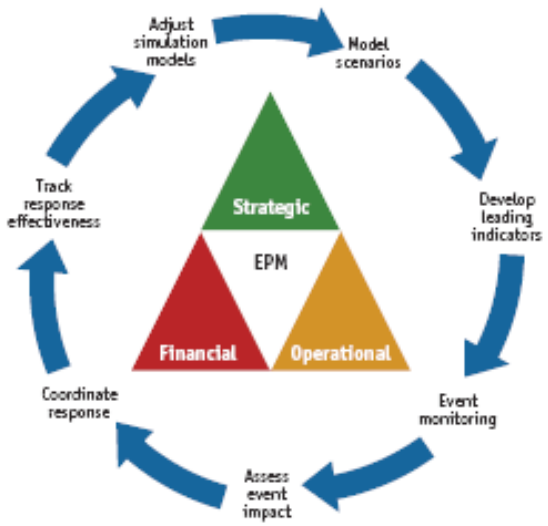

Figure 1: EPM Performance Cycle

Viewed as a continuous series of stages (see Figure 1), it covers the entire performance management life cycle:

- Model performance, opportunities and risk
- Develop scenarios for performance variance, risk events and business opportunities
- Put in place and maintain "closed loop" measurement systems
- Understand those metrics that are the company's leading indicators of future business activity
- Monitor occurrence of risk events and market opportunities and assess performance impacts across the entire enterprise value chain
- Coordinate the formation of appropriate strategic responses or tactical adjustments
- Support execution of the required actions
- Track and report actual impact of actions
- Adjust simulation models and underlying drivers based on actual performance

Performance, opportunity and risk management are all well-established business practices. However, it is crucial for finance organizations to expand their view of performance from their specific functional domain and lead the charge in elevating performance management to the enterprise level.

At the same time, finance organizations need to incorporate risk management into the EPM framework. As with EPM, enterprise risk management should be implemented as an integrated, top-down approach to managing risk and must move beyond the historical, functionally focused definitions of risk such as credit risk, loss prevention, insurance and compliance. The risk management model should reflect a comprehensive view of internal and external risk, including:

- Geopolitical
- Foreign exchange
- Interest rate
- Regulatory
- Market
- Operational
- Supplier
- Credit
- Liquidity

Companies that are most successful at adapting to the era of volatility will thrive, while those that cannot do so risk decline or even obsolescence. Finance needs to take an active leadership role in driving their organizations to be more proactive in strategy. They must be at the forefront in expanding performance management and integrating risk management at a truly enterprise level.

None of this is going to happen by accident. Companies need the support and direct involvement of senior business leadership and representation from all areas of the business along with a fundamental recognition that the past is no longer an accurate predictor of the future. The status quo is no longer sufficient to meet the challenges of the age of volatility.

About Tom Willman

Tom Willman is the Global Practice Leader of the Enterprise Performance Management Executive Advisory Program for The Hackett Group. With more than 15 years of experience in finance, accounting and consulting in a wide range of industries, Mr. Willman focuses on helping CFOs and other finance executives transform their organizations by deploying more efficient and effective processes, service delivery models and enabling technologies. Mr. Willman may be contacted at twillman@thehackettgroup.com.

Tracking Performance Trends to Drive Better Risk Management

Robert Torok, IBM Global Business Services

Performance management systems not only provide a means of measuring success for current business activities and a view of planned activities for the future, they also act as a warning signal for risk.

Q How can performance management initiatives support risk management portfolios within an organization? Are there specific finance processes that offer early returns for detecting and managing risk?

The objective of a performance management system – and its underlying management processes – is to enable managers and executives to understand what is going well, what is not, and what the future might look like, given data from the past.

Similarly, the objectives of a risk management process are to provide warning signals of impending or potential events that may impact the organization, and quantify those impacts, while enabling the organization to assess the efficacy of its mitigation strategies.

But there is frequently a gap between these two processes. This is because the performance management and risk management processes are not intertwined, with risks being assessed and managed without a complete understanding of the broader performance implications, while performance decisions are often made without regard for the risks they may inadvertently aggravate or mitigate. Both of these can be looked at through the metaphor of a rock being thrown into a pond: the first ripple is quite large and substantially disturbs the water around the point of impact, but each successive wave causes ever smaller ripples.

In bringing these two processes together, it is clear that strong performance management systems should incorporate measures of risk and be able to predict future results if risks materialize and/or risk mitigation actions are taken.

Consider the following example:

1. The organization starts with a traditional balanced scorecard, as shown in Figure 1. We will focus on customer metrics, shaded lightly in this figure. But there is a significant element missing here, namely, the risks associated with the customer metrics/targets and how the organization can get a warning signal that the risk might, in fact, materialize.

Area	Objectives	Measurements	Targets
Financial	1. Exceed market growth 2. Profitable growth	1. Sales growth 2. Margin growth	1. + 2% / year 2. + 5 % in 3 years
Customer	1. Perceived value for money 2. Relationships at multiple levels	1. Customer survey 2. # of contacts with targeted sponsors	1. Rated #1 by 75% 2. 100%
Internal	1. Maximize customer retention 2. Develop regional markets 3. Identify profitable new markets	1. Win/loss rate 2. Potential revenue in sales pipeline 3. # of potential customers	1. 60% + in target segments 2. Increase by 30% 3. Double in 2 years
Learning	1. Develop marketing skills 2. Develop customer database	1. % of strategic skills available 2. % of customers with key attributes known	1. 100% in 2 years 2. 80% in 2 years

Figure 1: The Balanced Scorecard
Source: Kaplan & Norton, The Balanced Scorecard, Figure 10.7

2. Periodically, let us say monthly, traditional performance measurement systems would report customer survey results and number of contacts, with those results analyzed by region, service area, business unit, etc. But these results are received weeks after the fact, and therefore any corrective action might be too late.

3. Hence, the first additional measurement: a warning signal every time a customer does not rate the organization #1 (the target or desired score). This is shown in Figure 2 under the column "Leading KRIs."

Area	Leading KRIs	Impact of Risk Event	Prevention / Mitigation Actions	Impact of Actions
Customer	1. Incidence of rating other than #1 2. # of contacts, new and/or renewed by month	1. For every 0.25% of shortfall in ratings, revenue loss is $8 million 2. Each new contact is worth $500K/year in revenue	1. Wider authority to customer service to resolve issues 2. Offer incentives to sales force to add & renew contacts, with qualifying criteria	1. Additional customer service costs of $1 million / year 2. Incentives will cost $400K / year, including allowance for 'contact loading'.

Figure 2: The Extended Balanced Scorecard

4. A second key data element is also required, shown in the column "Impact of Risk Event," indicating the consequences of not meeting the desired target. Now, the performance management system is beginning to add value: the organization not only has a target and a set of actual results, but it also understands what will happen if the risk event or adverse trend materializes.

5. However, even that is not enough, as the organization seeks to counteract each risk event, in this case a negative customer rating. One common solution is to offer something to compensate a dissatisfied customer at the point where the customer interacts with the organization, such as a hotel check-out desk or during a visit by a sales representative—and before the customer formally evaluates the organization. If the organization's representative identifies a potential problem, they may be given the authority to act immediately, as shown in the column "Prevention/Mitigation Actions" of Figure 2.

6. Now we can extend the performance management system even further. We can ask about the impact of these corrective actions, as shown in the column "Impact of Actions." In effect, what this suggests is that the risk of lower customer satisfaction ratings can be mitigated by granting client-facing staff the authority to solve the problem immediately but at a cost. And if the problems are severe enough, that cost might mean that the organization fails to achieve its financial targets!

Therefore, the most effective way for performance management systems to support risk management is to incorporate those measures that predict events or trends, as well as enable the tracking of mitigation actions. The latter situation is shown in Figure 3, where we have added the period results of our risk mitigation actions, such as tracking the spend on customer service actions as well as the change in performance ratings resulting from those actions.

Area	Prevention/ Mitigation Actions	Impact of Actions	Period Results	Common Actions
Customer	1. Wider authority to customer service to resolve issues	1. Additional customer service costs of $1 million / year	1. Spend of $430K by service representatives 2. 17% reduction in ratings other than #1 from prior period	1. Reduction in price charged or future discount offered 2. Free goods or services to customer 3. Apology from senior site manager or executive

FIGURE 3: RISK TRACKING DATA

The role of Finance is these areas is to provide the analytical tools and capabilities to enable performance metrics to be estimated, calculated, interpreted, and reported to senior management. But through it all, it's important to keep in mind that the ultimate goal is not keeping score, but improving the score!

About Robert Torok

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Leveraging Performance Management to Support Risk Management

Gary Simon, Group Publisher,
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Performance management systems and processes not only provide a means of measuring success in current business activities, they can also act as a warning signal for risk.

Q. How can the processes associated with financial consolidation and financial reporting improve risk management?

For at least two decades, risk management and financial reporting have been travelling along parallel but often diverging paths. This is not to say that the finance function is unaware of risk; indeed the finance function is steeped in a tradition of prudence and conservatism. But the formal process of risk management is often organizationally divorced from the finance function and the relentless pursuit of better performance has frequently gone unchallenged from a risk point of view.

Superficially, the apparatus of risk management (audit committees, internal audit, external audit and compliance) is in place, but the credit crunch and the financial crisis which followed it illustrate the frailty of the arrangements and just how easily unfettered risk-taking can take precedence over sound management. So, does performance management have a role in curtailing excessive risk taking?

One of the key lessons learned from the credit crunch is that risk management or GRC (Governance, Risk and Compliance) has to be inextricably linked to financial reporting. This not only applies to statutory reporting, but arguably more importantly to regular monthly management and performance reporting. In a volatile economy, new risks can emerge and subside at a moment's notice. Therefore risk management has to be a continuous process, deeply embedded in financial reporting, constantly testing the 'temperature of the water' and serving as an early warning system. But how is this achieved in practice?

Multinational, distributed organizations face a complex array of operational, reputational and financial risks, giving rise to a commensurately complex control environment – a system of application and general controls that need to be monitored regularly. Realistically, no organization can achieve blanket coverage. But careful prioritization of risks can support a cost-effective approach to addressing the most likely problems.

Early solutions to risk management and controls reporting arose from the introduction of Sarbanes-Oxley. However, these applications tended to be limited to a repository of documented controls, testing regimes and results which sat outside of the scope of financial reporting. Therefore it was not feasible to draw a link between controls (and the risks they were governing) to the disclosures they supported in the financial statements.

However, in recent times there has been a merging of process, technology and organization so that controls reporting is increasingly becoming embedded in performance management applications. This offers the possibility of tracing numbers that appear in, say, a balance sheet, back to the hierarchy of controls on which they rely. In this way, integrated controls and performance management can provide a foundation for monitoring and managing risk.

"Given the appropriate tools, process and organization, a performance management system can drive a much more cohesive and relevant approach to risk management."

Take, for example, the financial close process. The dependability of the final cash balance reported in the balance sheet usually relies on the completeness of bank reconciliations in each individual reporting entity and the agreement of intercompany balances among many other close tasks at the balance sheet date. In an integrated GRC and performance management environment, incomplete tasks and controls can be flagged in the system automatically, giving both a quantitative and qualitative measure of severity. The same thinking can be applied to key performance indicators (KPIs) where, for example, the system can help to manage risk by enforcing the review of assumptions or the re-submission of rejected forecasts that are overdue, reducing the risk of overly optimistic forecasts.

So, given the appropriate tools, process and organization, a performance management system can drive a much more cohesive and relevant approach to risk management. Nevertheless, the effectiveness of this approach relies on the pervasiveness of the controls environment, the visibility of integrated performance management and GRC across the business together with the collaborative tools to support timely intervention. Finally, organizational controls must be watertight to ensure that management cannot simply override the controls when it suits its purpose.

About Gary Simon

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Viewing Performance Management through a Risk Lens

Delbert Krause, Business Unit Executive, Cognos Software, IBM Business Analytics

The importance of risk management is growing. But many organizations are not satisfied that they are addressing risk effectively.

Q **Could finance organizations close this gap by incorporating risk management capabilities into their performance management processes?**

Risk management is top of mind for many finance organizations today. In fact, in the recently published IBM 2010 Global CFO Study, CFOs were asked how important risk management was to their organization, and how effective they were at managing risk. The results paint a challenging picture. While 77% indicated that risk was very important, only 55% felt they were addressing it effectively.[1]

Unfortunately for many finance organizations, their day-to-day activities focus mostly on processes to support transaction management, culminating in measuring and reporting on financial and operational performance. Risk management is often a secondary activity, performed by risk management specialists. But now CFOs and finance teams are quite rightly looking to address the gap between importance and effectiveness. One place for them to start is in an evaluation of where performance management processes impact risk measurement and control.

Most companies are already establishing or improving their performance management processes and systems across areas such as planning and forecasting, reporting and analytics, financial consolidation and corporate reporting. Connections between performance management and risk can easily be embodied within these systems.

Let's take a look at three specific areas where companies can quickly introduce risk management capabilities.

Planning as an early warning system. Planning, budgeting and forecasting all have a common element – they offer a forward looking view into performance through the financial and operational data of an organization. Whether it's a cost center budgeting and control plan or a sophisticated revenue plan by customer or product, the information can be evaluated through a risk lens. Are there new or increased variances relative to the original plan? Are those variances material and can we measure their impact by comparing historical trends? Are there changes in customer or channel behavior that should cause us concern – perhaps a sudden increase in the volume of closed business, which might point to

"Planning is one of the few times that organizations look forward across the business. Let's include risk in the planning process."

risks on contracts? Companies should review their plans and include metrics and measures that will help them track risk factors. They should consider new ratios and data that would highlight the potential for extreme, unexpected costs or sudden swings in revenue. Planning is one of the few times that organizations look forward across the business. Let's include risk in the planning process.

Reporting as a detection and measuring system. Reporting fluency in most organizations is very high. In fact, many organizations have more reports than they know what to do with. The critical question as to risk management is – do the reporting systems offer metrics that can help organizations assess and understand risk? While many reporting systems reflect financial and operational performance – and their associated variances – including risk as part of performance management reporting will help expose important risk insights. And creating the right reporting environment is fairly straightforward today. The breadth of functionality available in modern business intelligence systems enables an organization to maintain: 1) a framework to support and deliver data from virtually any source or combinations of sources, 2) a full suite of reporting, charting, and information delivery capabilities, 3) connections to the fast pace of business by delivering information over smart phones and through e-mail alerts. In short, companies have at their disposal the tools to include information in reports that can be extended to incorporate risk exposures. One example is measuring forecast quality by comparing forecasts over time, and identifying which forecasts show enough variability to expose the company to risk. The opportunity to establish regular reporting processes to understand risk is tremendous.

Performance management as a controls evaluation system. The advent of Sarbanes-Oxley in the United States and internal control mandates elsewhere have led to vastly improved internal control structures in most companies. The risk management view enables us to monitor and measure the effectiveness of those controls in the context of business data flowing through the organization. Not only can we map actual financial and operational details against internal controls, we can also include history to evaluate trends and plans to identify the effectiveness of existing controls.

Performance management processes and systems are intertwined with sensitive and critical company data. In many cases simply adding a risk lens will increase the visibility and understanding of risk factors throughout the organization. The important message here is that, with a minimum of effort, risk management can be an integral part of your planning, reporting and consolidation processes.

[1] IBM Institute for Business Value, *The New Value Integrator: Insights from the Global Chief Financial Officer Study,* March 2010

About Delbert Krause

Delbert Krause is the Business Unit Executive, Financial Performance Management Solutions, for Cognos Software in the Business Analytics division of IBM. In addition to his formal training in finance, Mr. Krause has more than 20 years of experience in consulting, selling, and marketing performance management software solutions for finance, business and IT users. Mr. Krause can be reached at delbert.krause@ca.ibm.com.

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