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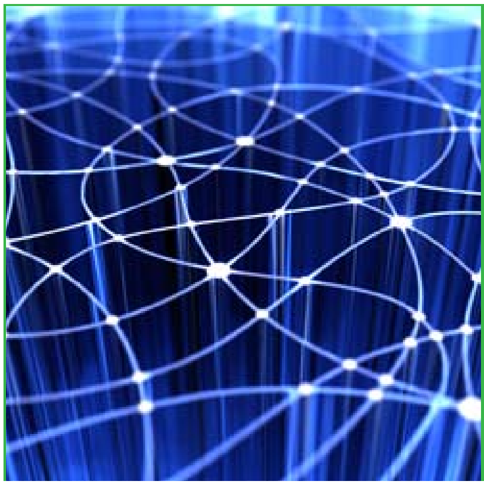

Connecting the dots: managing organizational risk

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Many companies today are dying on the vine—but don't realize it. And it's not because they're failing to execute. It's because they're not effectively tracking and reacting to what's going on around them. Companies need to look beyond data silos to get the big picture, both in-house and in the marketplace. Survival depends on it.

This is the fourth in a series of six articles seeking to establish a new agenda for finance. In the first, David Axson and Greg Hackett make a case for change, providing a wake-up call to today's finance leaders, and the second describes the new vision in greater detail. The third article discusses transforming the planning process to make it simple, flexible, short, and relevant to today's dynamic business environment. This fourth installment addresses a rapidly emerging role that finance is being asked to take on -- that of risk manager. This goes beyond the traditional compliance, credit, and treasury risk management roles to embrace all aspects of organizational risk. Organizational risk management encompasses the impact of external, organizational and execution factors that are increasingly key determinants of corporate performance and survival.

David Axson and Greg Hackett are advisors to the IBM Cognos® Innovation Center for Performance Management. They also are unflinching advocates for innovation in business management practices. Both question the effectiveness of the status quo and urge companies toward better ways of doing business.

The next two articles will elaborate on the implications of the vision on management reporting and measurement and also describe an implementation road map. Read on as David Axson describes how to recognize signs of danger and then take action.

Jeff Holker
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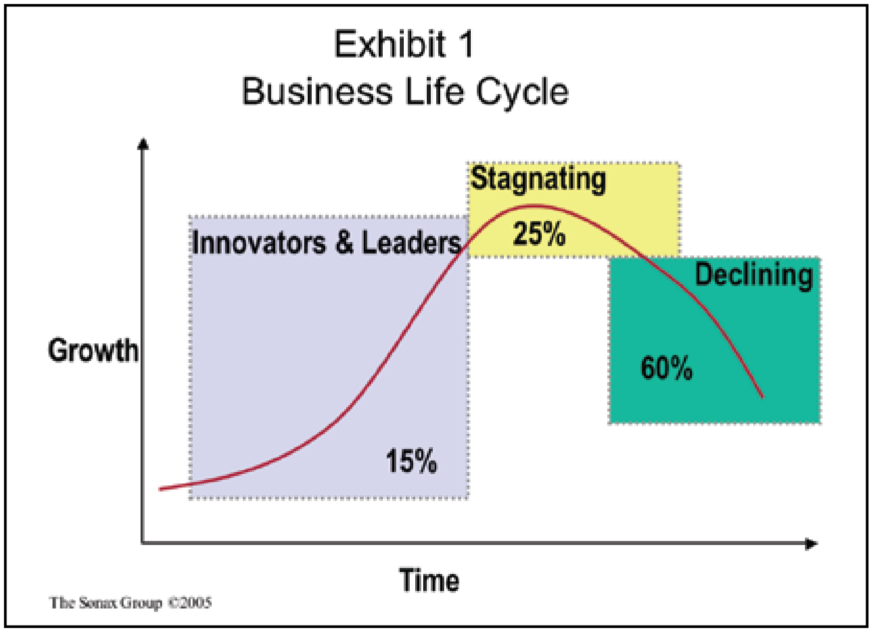
Success is fleeting for most organizations

If the life cycle of a corporation were plotted on a bell curve, at any given time, only about 15 percent of companies would be in their ascendancy – today's innovators and leaders. An additional 25 percent sit at the top of the bell, mature (and stagnating). The remaining 60 percent are encumbered by moribund products or markets and are in decline. (See Exhibit 1.)

What causes companies to stagnate? Unexpectedly, it is not poor execution that endangers organizational survival. Very often, companies stagnate, decline, or die because they miss, minimize, or fail to adapt to profound external changes. The factors are many. Success attracts new competitors, and old ones deteriorate. Product life cycles compress. Innovation is stifled as bureaucracy takes hold. Demographics shift, and customer loyalty is tenuous at best. As companies attain leadership they become attractive and visible targets for increasingly active and vocal special interests. Technology advances unabated. Regulation surges everywhere. Globalization is unstoppable as global markets, supply chains, and offshoring take hold.

These factors progress to issues stealthily. But the cumulative effects across time are not noticed by companies, because no one inside is accountable for gathering and analyzing the intelligence on trends and their likely impact. The external information gathering effort today is typically episodic and fragmented, with the resultant data obscured in silos and not shared. Unquestionably, individual issues are monitored in pockets of the company: Marketing conducts its own research on customer preferences and competitive trends. Sales talks to customers. Finance analyzes credit risk. But no one is observing external and internal risk factors holistically to assess their implications on the health of the company. Then a cascade of dominoes stuns, wounds, or kills.



Companies miss the danger signs for a number of reasons. For one, the challenge of running day-today operations is so great that little time is left to look outside. In addition, management and stakeholders have a short-term focus. No one has responsibility for understanding the external and internal environment – no one internal organization has ownership. No early warning mechanisms exist. The bias is typically toward the banking of internal data. Useful, actionable information on external factors is scarce, with no systematic collection and no one dedicated to its analysis. Plans provide great detail on what an organization is going to do and the results it expects, but little consideration is given to uncertainties in the outside world and how they could impact these carefully crafted strategies and plans.

Build a risk-based early warning system

To remedy this situation, companies must establish a risk-based early-warning system, to recognize major threatening trends that take years to emerge, and to assess the degree of exposure to the business. Finance must take the lead, becoming the eyes on the outside of the corporation – as well as the inside – with radar up, scanning the horizon and the organization for threats and opportunities. Developing an effective organizational risk management capability requires finance to fully leverage many of the tools it has become accustomed to using in recent years—but with a new focus and discipline.

A company's organizational risk profile is comprised of three components (Exhibit 2):

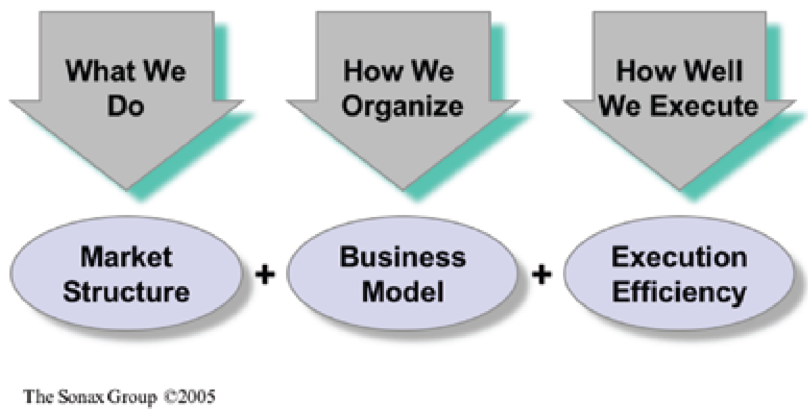
1. External environment and market structure

2. Internal business model and structure

3. Execution efficiency

The external environment and market structure identifies the risks an organization incurs through the choice of markets in which it participates and the structure of those markets. Complexity and volatility are directly impacted by the structure of a market as participants in the telecommunications and the utility industries can readily testify. Both offer graphic examples of how organizational risks increased exponentially in a very short period of time driven by a combination of rapid technological innovation and significant regulatory change that altered the structure of each market. Both industries were transformed from being relatively staid and predictable into volatile, high-risk businesses in relatively short order. Many new players emerged and many established players vanished from the scene. Remember that in 1985 Enron was still called Houston Natural Gas and was a relatively sleepy manager of gas pipelines.

Exhibit 2
Components of organizational risk



The second component is the business model and organizational structure that a company adopts in order to participate in its chosen markets. Taken together the business model and organizational structure reflect the choices made by the company in pursuing its chosen strategy. For example, both State Farm and Progressive Insurance are major players in the U.S. auto insurance market yet each has adopted a very different business model. State Farm sells through 16,000 agents across the United States while Progressive has chosen a direct sales model. Beyond the sales and service delivery model there are a number of other factors that impact the level of organizational risk an organization incurs as a result of its business model. Choices around the level of standardization of policies and practices, the use of technology, the deployment of best practices, and the management of employees all affect an organization's risk profile.

The third component addresses how well an organization executes given its strategy, business model, and organizational choices. This is the area that is best served by today's planning and measurement systems since measures of execution include most output or results based measures such as revenue, earnings, quality, cycle time, service levels, and productivity.

Exhibit 3 illustrates some of the factors that contribute to each component of organizational risk. A key insight for finance teams is to understand that an organization's execution efficiency and hence results are materially influenced by the first two variables – market structure and business model. For example, a company that operates in a fast moving, highly volatile market and that has chosen a decentralized organizational model with few common processes or systems will incur higher risks than a company that is competing in a more mature market and has a more centralized and standardized business model.

Finance as custodian of an organization's planning, reporting, and analysis processes needs to lead in the understanding and management of organizational risk. The first three steps are to:

1. Establish the external risk profile of the organization by assessing overall market complexity and volatility

2. Determine the organization's internal risk profile based upon its chosen business model

3. Evaluate the execution efficiency of the organization in each core business process and in aggregate

Exhibit 3
Drivers of operational risk

Market Structure	Business Model	Execution Efficiency
• Number of participants • Degree of concentration • Level of regulation • Competitive environment • Rate of business growth • Capital intensity • Barriers to entry • Product life cycles • Availability of alternatives • Risk of obsolescence	• Governance model • Capital structure • Organization structure • Product/service delivery model • Process complexity • Technical complexity • Sourcing strategy • Best practice utilization • Management discipline • Staffing and skills	• Revenues • Earnings • Cycle times • Growth • Quality • Service levels • Risk • Productivity • Market position/share

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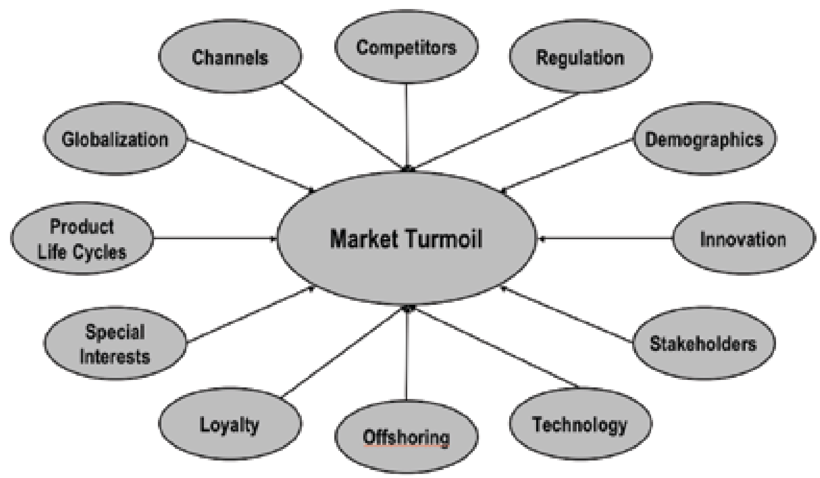
Many components of this approach exist today. The challenge is that much of the information is assembled in an ad hoc manner and there is no unifying process to provide a complete organizational risk profile. Moving from an ad hoc and largely subjective process to a systematic, fact-based measurement system is the objective.

Understand organizational risk

Issues emerge as pressure points over many years. Then they tend to behave like dominoes, cascading in causal relationships that rapidly affect multiple organizations. Consider the political, social, and regulatory issues that have arisen around offshoring or the impact of Eliot Spitzer's investigations into the securities, mutual fund, and insurance industries.

To prepare for and respond to such threats, finance needs to be able to identify trends and to determine materiality and probability. A starting point is to analyze drivers of external change and determine how they affect the organization, such as demographics, technology, globalization, channels, competitors, and regulation. (See Exhibit 4.)

Exhibit 4
Drivers of external change



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With an examination of the key external change drivers in hand, finance should first assess what the company already knows. Information in silos throughout the corporation should be ferreted out and amassed. Using new technologies that enable the aggregation and organization of data from multiple sources can speed this process greatly. Data gathered in one part of the business could prove invaluable to another.

But to be at all effective in establishing a risk-based early-warning system, companies must get beyond the data in the ERP system. In parallel with the internal data assessment, finance must look outside, seeking those trends or events that signal opportunity or threat. Numeric data is important, but companies must look beyond to the more difficult to obtain and systematize qualitative data.

With internal data assembled and external inquiry under way, finance can begin to identify gaps in the company's intelligence and proceed to fill them. The emerging picture provides an organizational risk profile of the corporation that can serve as the trigger for thinking about how to respond and embed the appropriate actions in strategic and operating plans.

A set of risk factors will emerge that requires monitoring. Measurement involves identifying leading indicators and sources of data relative to positive or negative trends around a corporation's key risk factors. These leading indicators can be programmed into the organization's performance management system to provide early warning as a prompt for management action.

Finance must educate the company on the emerging threats and what might happen. The challenge is to not just scan the horizon, but to transmit the information across the company and to drive through to planning and action and realignment of the culture. Again, appropriate use of technology to filter and focus this information can promote early recognition and action.

To ensure full leverage of data regarding risk – and to eliminate the silos of external intelligence – finance will establish an enterprise risk-management team. This team is not staffed by accountants. A small team of analysts is supported by futurists, economists, sociologists, anthropologists, and the like, with the requisite skill sets and expertise predicated on the factors that most threaten a company. As data on external threats and internal risks begins to pulse through the organization, all business plans will explicitly address organizational risk.

Finance will be leaders not only in conveying new information that anticipates the future, but in advising senior management, redefining the decision culture, reallocating resources, and driving change. Such an effort is vital to corporate survival, permitting companies to either stay in the business and get ready for future trends – or to prepare to exit a business at the most attractive moment. A risk-based early-warning system buys time to change direction.

Adding a systematic assessment of an organization's organizational risk profile benefits many different constituencies. First of all, investors, lenders, and regulators can better understand the drivers of overall financial performance and derive insight into potential risks or opportunities that may lie ahead. For example, if an organization is about to embark upon a major acquisition, the knowledge that the acquiring company does not have a stable, scalable, and standardized computer systems environment should alert investors that there is a significant risk of integration problems if the deal is consummated. Understanding the corporation's organizational risk profile allows stakeholders to better answer key questions such as:

- Do the company's chosen business model and execution capability support the financial results and measures?

- How well positioned is the company to respond to emerging trends—both opportunities and threats

- Does an organization's strategy effectively recognize the varying types of market risk it will encounter, and is management taking adequate steps to ensure that the appropriate skills are available?

Board members also benefit from an increased understanding of an organization's risk profile. Being a member of the board of directors of a major corporation used to be a fairly benign position. Often attained as a confirmation of one's standing in the community, board membership entailed lavish hospitality and little onerous work. All that has changed, in addition to exercising fiscal stewardship over the companies on whose boards they serve, directors must also seek assurance that the organizations' management processes are effective in capitalizing on new opportunities, while assuring an acceptable level of risk and control.

Effective organizational risk management is no longer an option. Any improvement in the ability to predict future performance – either positive or negative – offers managers the most valuable commodity of all – time to think and act.

About the author

David Axson is a partner in The Sonax Group and an advisor to the IBM Cognos Innovation Center. He is the author of the book "Best Practices in Planning and Management Reporting" published by John Wiley. He can be contacted at daxson@sonaxgroup.com.

About the Sonax Group

The Sonax Group is a consulting and advisory firm redefining business management practices. Established by David Axson a cofounder of the renowned benchmarking and finance transformation authority The Hackett Group, the firm works with executives to improve the effectiveness of their planning, performance management, and decision-making processes, radically simplifying and refocusing them to achieve flexibility, agility, confidence, and consistency.

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The IBM Cognos Innovation Center is dedicated to transforming routine performance management practices into "next practices" that help cut costs, minimize risk, streamline processes, boost productivity, enable rapid response to opportunity, and increase management visibility.

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