Leveraging Performance Management to Support Risk Management

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This essay is 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.

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.

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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

Gary Simon is the Group Publisher of FSN Publishing Limited, Managing Editor of FSN Newswire and the author of many product reviews and white papers on financial software. Simon is a graduate of London University, a Chartered Accountant and a Fellow of the British Computer Society, with more than 23 years of experience implementing management and financial reporting systems. Simon was a partner with Deloitte for more than 16 years and has led some of the most complex information management assignments for global enterprises in the private and public sector.
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