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Manage Risk – Make Money

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In corporate life—as in personal life—risk is inescapable. Markets change. New competition emerges. Natural or economic disaster strikes. What does your company do about risk? Do you ignore it, hoping it'll go away? Or do you use risk to help create real value for your stakeholders?

In this article, David Axson argues for the latter. He shows how you—like so many savvy companies do—can apply solid corporate performance management practices to both identify and utilize risk. The result? Sustained growth and profitability!

"Manage Risk—Make Money" is part of a series of papers written for the IBM Cognos Innovation Center by David Axson, founder and president of the Sonax Group. David is former Head of Corporate Planning at Bank of America and co-founder of The Hackett Group. In this series, David draws on research and material from his second book, *Best Practices in Planning and Performance Management*, published by John Wiley & Sons. The book provides practical insights into the ways world-class companies leverage corporate performance management processes and systems to attain and sustain superior performance.

Jeff Holker
Associate Vice President
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Manage Risk – Make Money

"The capacity to manage risk, and with it the appetite to take risk and make forward-looking choices, are key elements of the energy that drives the economic system forward."

Peter L. Bernstein, Against the Gods: The Remarkable Story of Risk

Historically, risk management has been all about minimizing losses; however today's leading companies are seeing effective risk management as a strategy for sustaining profitable growth, and hence an integral part of their corporate performance management (CPM) process. So what are the implications for your performance management practices?

Uncertainty, volatility, and unpredictability have come to characterize the environment in which all organizations now operate. As we have seen in earlier papers in this series, many managers understand the futility of trying to plan out future performance in great detail. Changes occur with such frequency and velocity that static annual plans simply cannot hope to plot a course that remains valid for more than a few weeks. But what is the alternative? Many managers are turning to risk-based planning techniques as they seek to adapt to ever more volatile and uncertain markets.

The first step is to recognize that simply ignoring risk does not make it go away. In fact, the elimination of risk is not the objective. Risk-taking is fundamental to a company's ability to create value. Investments in new products, research into new technologies, acquisitions and divestitures, or the redesign of core business processes all incur risk. Those organizations that can manage such risks for profit emerge as leaders. Consider Best Buy's rise to dominance in the historically fragmented field of consumer electronics retailing; Nike's evolution into a global sports brand; and American Express's ability to grow share in the intensely competitive credit card business. Each of these companies made calculated, data-driven decisions to embrace risk as a means of securing a vital advantage in the marketplace. Together with other leaders, these organizations are seeking to derive greater insight into both the positive and the negative impacts of risk on future performance.

Companies should look to their CPM systems as vehicles for identifying, monitoring, and managing risks as part of an integrated performance management process. Increasingly, success is being defined by those organizations that can anticipate and react best to changes in the marketplace, therefore those that can harness the relevant data and derive insight that supports timely decision making will have a distinct advantage. Two forces combine to accelerate the adoption of more dynamic, risk-aware performance management practices. First, the ripple effect of unpredictable one-time is becoming greatly magnified as the global economy becomes more tightly integrated. Second the continuing pace of technological change is accelerating the rate at which new trends become material *(Exhibit 1)*.

Exhibit 1
An Increasingly Volatile World

Unpredictable One-Time Events	Rapidly Emerging Trends
♉ 9/11	♉ Offshoring
♉ Asian Tsunami	♉ Broadband
♉ Hurricane Katrina	♉ Sustained high commodity prices
⛎ Long-Term Capital Management	⛎ China & India
♉ Enron, Worldcom	♉ Aging population

Source: Sonax Group

No More Excuses

Historically, managers have used the negative impact of one-time events that are outside their control as excuses for shortfalls in performance, a trend which continues to this day. Numerous companies cited the impact of 9/11, Hurricane Katrina, or the Asian tsunami as explanations of poor results. However, we are seeing a significant change in how these excuses are viewed by investors and other stakeholders. Instead of giving management a free pass for the impact of such events, many observers are looking at how an organization responds to

such challenges. Those that handle adversity the best can command a premium relative to their excuse-giving peers. An excellent example of this was the stellar performance of Southwest Airlines in the months after 9/11-in stark contrast to peers such as United, US Airways, Northwest, and Delta, which all filed for Chapter 11 bankruptcy protection.

The degree of interdependence among companies, markets, and economies, combined with the increasing speed of communications, is accelerating the pace at which trends move from emerging and interesting to established and dominant. For managers trying to preserve leadership positions in fast-changing markets or to establish leadership positions in new markets, the need for adaptability, speed, and not a little luck is clear. Of the over 7,400 companies that have gone public since 1980, 25 percent have gone out of business-and no, they were not all dot-coms.

Threat of Irrelevance

Perhaps the biggest risk organizations face, and one of the least understood, is the threat of becoming irrelevant to one's customers. From the days of the oft-cited buggy whip manufacturers whose whole business became irrelevant upon the introduction of the automobile, companies have been exposed to the risk that customers simply no longer want, need, or value their goods and services. The economic landscape is littered with the relics of once-mighty companies that lost a vital connection with their customers. Building intelligence into an organization's performance management processes to assess the continued relevance of products and services is crucial if an organization is to identify and respond to the threat adequately. Measuring the risk of irrelevance first demands that an organization understands its attraction to customers. For example, how relevant would H & R Block be, if the United States introduced a flat tax with no deductions; Exxon Mobil, if non-oil-powered vehicles and sources of electricity predominate; Starbucks, if caffeine were found to be carcinogenic; or Netflix if

(when?) broadband video on demand becomes ubiquitous? After all, it is not that long ago that Wang, Woolworth, AT&T (the old one, not the reincarnation), Pan Am, the American textile industry, the British mining industry, and network television dominated their respective markets. *Exhibit 2* highlights a few of the change-drivers that can heighten the risk of irrelevance.

Exhibit 2
Drivers of Change

Factor	Examples
Consumer taste	Atkins Diet
Technology innovation	Video to DVD, CD to MP3
Regulation	IRAs, Health Savings Accounts
Competitive model	WalMart, Dell, Southwest
New product innovation	iPod, YouTube, MySpace
Execution failure	Kmart, U.S. auto industry
Current events	9/11 - Homeland Security
Collusion	Archer Daniels Midland, Sothebys
Ethical failure	Tobacco companies
Technology/process failure	Northeast U.S. blackout in 2004
Leadership	Sunbeam, Enron, Worldcom
Values	Mothers Against Drunk Driving
Environment	Toyota Prius, Aerosol cans

Source: Sonax Group

What is Effective Risk Management?

Historically, risk has been defined narrowly as the measurement and management of financial risk. Market price, interest rate, credit, and exchange rate risks dominated management's attention and have been well understood, if not always effectively managed. Such a narrow view is no longer sufficient. The impact of specific risk factors, from the stability of global supply chains to the threat of attack from special interest groups, represents just some of the increasing portfolio of potential risks that can impact performance.

Integrating an effective risk-management capability into the performance management process requires that an organization is able to:

- Identify the risks to which the organization is exposed.
- Quantify the materiality and probability of occurrence.
- Determine the need for mitigating strategies to be developed.
- Develop appropriate mitigation plans.
- Drive timely decision making.
- Monitor execution and results.

A systematic risk-management approach starts with a routine review of many factors that are not typically addressed by traditional planning, budgeting, and reporting processes, such as: the quality of the corporate governance, employee management, and customer management processes; the company's use of technology and its business interruption plans; the deployment of best practices; the sensitivity of the company's products to technological obsolescence; the adequacy of contingency plans against possible pandemics (e.g. SARS, avian flu); and the degree to which the company is subject to attack from special interest groups.

A Framework for Measurement and Management

It is no coincidence that many of the companies owning established leadership positions in their markets are also companies that have most effectively harnessed the power of technology to turn operational information into insight. Wal-Mart tracks the flow of products through its stores to ensure that shelves are never empty; Toyota dynamically adjusts its production schedule based on the flow of orders for different vehicles.

Risk measurement must be objective, fact-based, and consistent to ensure comparability and credibility. The aim is to identify and quantify major trends and assess the degree of exposure. These insights are typically assembled by planning, finance or-if the company has established one-the risk-management team. In many

companies, the emerging role of chief risk officer (CRO) is charged with developing a comprehensive understanding of the overall risk profile. The CRO serves as the eyes of the corporation, externally as well as internally, scanning the outside world and the organization itself for threats and opportunities.

The starting point for developing an effective risk management framework is to understand the level of business risk-and hence future financial risk-to which an organization is exposed. An organization must fully leverage many of the tools it has become accustomed to using in recent years, such as contingency planning, market and competitive intelligence, scenario planning and data mining-but with a new focus and discipline. 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 a largely subjective *ad hoc* process to a systematic, fact-based measurement system is the goal. *Exhibit 3* identifies some of the factors that should be considered in developing an organization's risk profile.

Exhibit 3
Potential Risk Factors

External	Organization Model & Structure	Execution
• Industry risk profile	• Governance	• Growth
• Channel complexity	• Process complexity	• Market position
• Rate of change	• Technical complexity	• Earnings quality
• Product churn	• Staff quality	• Productivity
• Customer loyalty	• Organization structure	• Cycle time
• Regulation	• Management practices	• Service levels
• Globalization	• Process discipline	• Process costs
• Barriers to entry	• Best practice utilization	• Process quality
• Special interest	• Information architecture	• Staffing levels
	• Systems archtecture	• Staff leverage

Source: Sonax Group

New technologies that enable the aggregation and organization of data are at the core of an effective process. Companies must look beyond the data in their enterprise resource planning (ERP) or general ledger systems: Key insights about markets, customers and competitors need to be aggregated together with rich internal intelligence in order to make balanced judgments about risk.

Having assembled a sound base of data, business risk measures can be built into the target-setting process that guides planning; however, companies should continuously evaluate the relevance of each measure over time, as the indicators themselves are subject to the same forces that increase or diminish the importance of the factors they measure. Not that long ago, phone companies touted the quality and availability of their dial tone as a competitive feature; banks, their ATM network coverage; and car makers offered antilock brakes and side airbags as options. Now all are competitive necessities and have little value as measures of differentiated service.

The Payoff

The value of building a systematic data collection and analysis framework for monitoring organizational risk goes beyond a one-time risk assessment. Over time, a set of risk factors will emerge that requires ongoing monitoring. These leading indicators can be programmed into the organization's performance management system to provide early warning as a prompt for management action *(Exhibit 4)*.

Exhibit 4
Example of an external business risk profile

	Risk Assessment (Low – High)	Commentary
• Industry risk profile		• Many new entrants
• Channel complexity		• Not excessive
• Rate of change		• Rise of generics
• Product churn		• Will rise over next 2 years
• Customer loyalty		• Price driven
• Regulation		• Increasing
• Globalization		• Increasing
• Barriers to entry		• Reducing
• Special interest		• Significant litigation threats

Source: Sonax Group

Understanding an organization's risk profile allows stakeholders to better answer key questions such as:

- Does the company's chosen business model and execution capability support financial results and targets?
- 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 risk it will encounter, and is management taking adequate steps to ensure that the appropriate skills are available?
- Does management make effective and timely decisions based on the insights gleaned from its risk management processes?

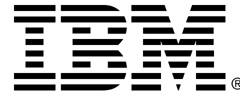
Board members also benefit from an increased understanding of an organization's risk profile. In addition to exercising fiscal stewardship over the companies on whose boards they serve, directors must also seek assurance that the organizations' management processes are effective in capitalizing on new opportunities, while assuring an acceptable level of risk and control.

Ultimately, the payoff from a risk aware set of performance management practices is the ability to seize opportunities and mitigate threats with speed and confidence; consistent execution drives growth in both the quality and predictability of earnings and in the creation of shareholder value.

In the next paper in this series, we will explore in more detail the process and systems requirements for developing an effective risk-based performance management process.

About David Axson

This article is adapted from the book Best Practices in Planning and Management Reporting by David A.J. Axson, copyright 2003 by David A.J. Axson and The Hackett Group, published by John Wiley & Sons Inc. Hoboken, New Jersey. David Axson is the founder and president of the Sonax Group and an advisor to the IBM Cognos Innovation Center.



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The IBM Cognos Innovation Center was established in North America and Europe to advance the understanding of proven planning and performance management techniques, technologies, and practices. The Innovation Center is dedicated to transforming routine performance management practices into "next practices" that help cut costs, streamline processes, boost productivity, enable rapid response to opportunity, and increase management visibility.

Staffed globally by experts in planning, technology, and performance and strategy management, the Innovation Center partners with more than 600 IBM Cognos customers, academics, industry leaders, and others seeking to accelerate adoption, reduce risk, and maximize the impact of technology-enabled performance management practices.

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