

# When Strategy and ERM Meet

BY MARK L. FRIGO

How risky is our strategy? What events and risk scenarios could ruin our business? Do we have the right countermeasures and risk management strategies in place? These are just some of the questions on the minds of executives and board members today.

One of the challenges facing management teams is how to link business plans and enterprise risk management (ERM). Recent events have shown us that strategy and risk management must be closely linked to be effective in protecting shareholder value. At certain financial institutions, investments in collateralized debt obligations (CDOs) and subprime mortgages resulted in higher returns and yields, but they carried much greater risk, which, in some cases, wasn't managed effectively. Less dramatic examples of ineffective risk management are seen every day and occur in areas like information security, supply chain disruptions, and a host of others.

In this article, I'll present three approaches that can help connect a company's strategy to its risk management efforts. As executives and directors review 2008 plans and strategies, they can use these ideas to improve ERM, with the ultimate goal of protecting shareholder value and corporate assets. The three approaches for effective strategic risk management are: (1) a strategic risk assessment process, (2) a process to identify and protect Genuine Assets that are at risk, and (3) strategic risk monitoring and performance measurement.

## WHAT IS RISK?

Strategic risk management needs to examine how well a business strategy will perform under different scenarios and events. It must look closely at scenarios where the strategy could perform so poorly that it could potentially result in significant losses, destruction of shareholder value, or a damaged corporate reputation. So strategic risk can be defined in terms of the risk scenarios that could potentially lead to significant loss of shareholder value. But risk scenarios should also consider the "upside" of risk (see the book *The Upside of Risk: The 7 Strategies for Turning Big Threats into Growth Breakthroughs* by Adrian Slywotzky, Crown Business, 2007). For example, Target sidestepped the competitive threat from Wal-Mart by focusing on a customer segment different from Wal-Mart's and achieved profitable growth opportunities in the process. As another example, Samsung, confronted with serious brand erosion and commoditization risk, turned its attention to building on product innovation, speed to market, and a strong brand to turn a position of weakness into a position of market strength.

Risk can include loss of tangible assets, and it can also mean the potential loss of one of the company's most valuable assets—its reputation—as shown by Robert Eccles, Scott Newquist, and Roland Schatz in "Reputation and Its Risks," *Harvard Business Review*, February 2007. Ultimately,

strategic risk management and ERM need to be connected with the potential impact on shareholder value.

In 2004, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) issued its *Enterprise Risk Management—Integrated Framework* with a definition of ERM (see [www.coso.org](http://www.coso.org)). Three key elements of the definition relate to strategy. First, ERM is directly related to strategy setting. For ERM to be effective, it must be embedded in and connected directly to the enterprise's strategy processes. Second, ERM is designed to identify events that could affect the company and the performance of its strategy. Third, a fundamental goal of ERM is to provide reasonable assurance that the enterprise achieves its core objectives or strategy. These three characteristics suggest that "strategic risk management" should be an integral part of effective ERM.

## STRATEGIC RISK MANAGEMENT AT HIGH-PERFORMANCE COMPANIES

Effective strategic risk management should provide a way for identifying and evaluating how a wide range of possible events and scenarios will impact a business's strategy execution, including the impact on the assets and shareholder value of the company. The Return Driven Strategy framework has been shown to be a useful framework for this (see the article by Mark Beasley and Mark Frigo, "Strategic Risk Management: Creating and Protecting Value," in the May 2007 issue of *Strategic Finance*). It represents the best practices of high-performance companies in managing the threats and opportunities in risk.

Research on high-performance companies can provide valuable insights about risk management. High-performance companies are vigilant to forces of change, and they manage risks and opportunities better than other companies. The Return Driven Strategy framework provides a way to evaluate the strategic risks of a company from the perspectives of shareholder value risk, financial reporting risk, governance risk, customer and market risk, operations risk, innovation risk, brand risk, partnering risk, supply chain risk, employee engagement risk, R&D risk, and communications risk. It also provides a useful framework for understanding the cause-and-effect linkages in critical risk scenarios and explains how those scenarios would play out in the business strategy and impact profitability, growth, and shareholder value.

(For more about Return Driven Strategy, see Mark L. Frigo and Joel Litman, *Driven: Business Strategy, Human Actions and the Creation of Wealth*, [www.returndriven.com](http://www.returndriven.com).)

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Shareholder value risk provides a high-level overview of risk and is driven by future growth and return on investment as reflected in the plans of the company and the company's perceived ability to execute on them. Anything that will impede growth and returns, including the risk of unethical activities of the company, should be considered in assessing shareholder value risk using the first tenet of Return Driven Strategy, "Ethically Maximize Wealth." **Financial reporting risk** is driven by reporting irregularities in areas such as revenue recognition, which can result in restatements of financial reports and be devastating to shareholder value. **Governance risk** is driven by factors such as controls and governance capabilities. **Customer and market risk** is driven fundamentally by the extent to which a company's offerings fulfill otherwise unmet needs, and this provides protection against competition. **Operations risk** can be driven by any part of the value chain and often surfaces with the inability to deliver offerings, which is at the heart of Return Driven Strategy. **Innovation risk** is driven by the inability to change or create offerings that fulfill customer needs better than your competitors do. **Brand risk** includes the risk of brand erosion and damage to a company's reputation. **Partnering risk** is driven by the activities of your partners, from vendors to joint ventures to other associations. **Supply chain risk** focuses on the increasing risk in outsourcing and global supply chains. **Employee engagement risk** is driven by the employment practices of the company. **R&D risk** is driven by the processes and pipeline of options for new offerings for future growth. **Communications risk** is driven by how well your company communicates internally and externally.

## A STRATEGIC RISK ASSESSMENT PROCESS

A simple process for strategic risk assessment involves four steps:

**1. Risk Assessment of Plans.** Strategic risk assessment can begin by conducting an overall risk assessment of the 2008 plan and strategic plan. This assessment includes scenario analysis.

**2. Identify Critical Risk Scenarios.** The next step is to identify and describe "critical risk scenarios" considering

the severity and likelihood of the events and scenarios.

**3. Identify Countermeasures.** Next, management identifies possible countermeasures for managing the critical risk scenarios and considers the cost/benefit of the countermeasures.

**4. Establish a Process for Continuous Monitoring.** Management establishes a process for continuous monitoring of the risk profile of the company, including the use of key risk indicators (KRIs) and best practices of performance measurement and performance management such as the balanced scorecard.

Here are some questions to address during a strategic risk assessment:

- ◆ What events or scenarios could create significant downside risk in your business strategy and 2008 plans?
- ◆ What countermeasures have been developed to address these risk scenarios and events?
- ◆ Has the company considered the upside of risk and how it plans to realize the opportunities?
- ◆ What are the roles of the CFO, general counsel, chief risk officer (CRO), internal audit, and others in assessing and managing the threats and opportunities in your plans and business strategy?
- ◆ How is enterprise risk management incorporated and embedded in your 2008 plans and business strategy?
- ◆ What performance measures and key risk indicators are you monitoring to continuously assess and manage strategic business risk?

**Risk Assessments**—One approach is to regularly assess strategy and plans from three perspectives: risks, opportunities, and capabilities (ROC). **Risks** are about risk of loss—the downside of risk, such as loss of revenue or loss of assets. **Opportunities** are about the upside of risk, such as opportunities for gains in revenue, profitability, and shareholder value. **Capabilities** are about distinctive strengths of an organization that can be used to manage the risks and opportunities.

**Tools for Risk Assessment**—There are many tools that can be useful in strategic risk assessment, including brainstorming, analysis of loss data, self-assessments, facilitated workshops, SWOT (strengths, weaknesses,

opportunities, threats) analysis, risk questionnaires and surveys, scenario analysis, and other tools described in the Statement on Management Accounting (SMA), *Enterprise Risk Management: Tools and Techniques for Effective Implementation*, published by the Institute of Management Accountants (IMA®) in 2007.

**Competitive Intelligence**—The area of competitive intelligence (CI) can be a valuable part of strategic risk management. CI is an integral component of fact-based strategic planning processes. It should definitely be part of strategic risk management and ERM. “The ethical collection and analysis of CI can reduce the risk associated with strategic decision making,” says Gary Plaster of the Capital H Group and a founding member of the Society of Competitive Intelligence Professionals. Around 400 B.C., Sun Tzu wrote in *The Art of War*, “Keep your friends close and your enemies closer,” which is one way of thinking about CI. For example, pharmaceutical companies are vigilant about being at trade shows and scientific meetings, and they monitor clinical trials in the industry. “War games” are used at pharmaceutical companies like Wyeth to develop plans to counter potential market moves by competitors. Competitive intelligence is a Genuine Asset that can be used to manage customer and market risks.

**Corporate Sustainability Risk**—One of the areas that’s often overlooked in risk management is related to corporate sustainability and corporate social responsibility (CSR). Connecting strategy and CSR is a challenge for executive teams, as Debby Bielak, Sheila Bonini, and Jeremy Oppenheim wrote in their October 2007 article, “CEOs on Strategy and Social Issues,” in *The McKinsey Quarterly*. The risks and opportunities facing companies in the area of corporate sustainability are more complex and have greater potential impact than ever before, and senior executives, board members, and managers are seeking better ways to manage these challenges and opportunities. In his book *Making Sustainability Work*, Marc Epstein presents a definition for corporate sustainability that’s useful in strategic risk management. He focuses on nine principles of sustainability: ethics, governance, transparency, business relationships, financial return, community involvement/economic development, value of products and services, employment practices, and protection of the environment. Each of these areas can be assessed as part of strategic risk management. For example, changes in environmental regulations and expectation of environmental standards for companies in a global business environment should be considered in risk assessment and risk management strategies.

**Risk Transfer and Retention Strategies**—One of the basic countermeasures for managing and mitigating risk involves risk transfer and retention strategies. After identifying critical risk scenarios, which include the potential effect on company assets and shareholder value, management must determine how much should be retained or transferred. The risk management strategy should consider whether to protect corporate assets by purchasing insurance, self-insuring, or creating a captive. This assessment will require a deep understanding of the types and limits of insurance and consideration of emerging legal, regulatory, and political trends; damage awards; geographic locations; available insurance products; and options as well as coverage law.

## GENUINE ASSETS AT RISK

Some of the most valuable assets of an organization aren’t on the balance sheet. Genuine Assets include the most valuable tangible and intangible resources and capabilities of an organization and must be protected because some of them may be at risk. Companies routinely insure tangible assets on the balance sheet to protect against loss. But what about protecting the Genuine Assets?

### What Are Genuine Assets?

Genuine Assets are the tangible and intangible resources, capabilities, and traits that make an organization and its offerings unique. As I mentioned, some Genuine Assets appear on the balance sheet, but many don’t. As the “building blocks” of strategy, Genuine Assets form the basis for creating sustainable competitive advantages. And only through these advantages can you plan and execute business strategy that leads to higher returns, higher growth, and, ultimately, increased market value.

### What’s the Value of a Genuine Asset?

When identifying these assets, be very specific as to what your Genuine Asset is. Describe specifically how it allows your company to accomplish its strategy in ways other firms couldn’t, thereby leading to higher performance. How difficult would it be for another firm to develop a similar Genuine Asset, allowing it to copy the activity that led to high performance? How long would it take? How much money would it cost?

### What Genuine Assets Are at Risk?

To help identify and manage the risk to Genuine Assets, management should ask three questions:

- ◆ What are the most valuable and unique capabilities

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and resources of the company?

- ◆ What scenarios and events could put the most valuable Genuine Assets at risk?
- ◆ What countermeasures can be developed to protect these assets?

Examples of Genuine Assets to consider in a risk assessment would include corporate reputation, customer information, competitor intelligence, vendor intelligence, specialized processes and capabilities, exiting patents and trademarks, and intellectual property that should be protected with patents, trademarks, and other means.

Customer information is an example of a Genuine Asset that must be protected. Information security is a big issue at most companies, yet breaches occur, sometimes with significant potential impact. For example, the British government recently announced that government workers lost two computer disks containing names, addresses, dates of birth, national insurance numbers, and banking information for approximately 25 million residents of the U.K., almost half its population. Effective risk management in the area of data security requires the right mind-set and attitude toward information security among employees. It requires an understanding and awareness that the information on a \$20 storage device or a \$1,000 laptop, if not protected, could result in potential loss of customers, corporate reputation, and shareholder value.

Some Genuine Assets can support and be part of an effective risk management strategy and can help protect a company against risks. For example, having a “Plan B” in place for potential disruptions in critical parts of the supply chain is an example of a Genuine Asset for effective strategic risk management. Another example is employees having a risk mind-set and risk attitude that support the organization’s strategy and risk appetite.

## **KEY RISK INDICATORS AND THE BALANCED SCORECARD**

Effective strategic risk management should be a continual process that includes metrics for continuous monitoring of risk. An organization’s key risk indicators and metrics should link to the potential impact of risk on shareholder

value. Frameworks such as the balanced scorecard can help management develop and use these risk metrics (see Mark Beasley, Al Chen, Karen Nunez, and Lorraine Wright, “Working Hand in Hand: Balanced Scorecards and Enterprise Risk Management,” *Strategic Finance*, March 2006). The balanced scorecard focuses on strategy and accountability and fosters a continuous process for risk assessment and risk management. Strategy maps also can provide a useful way to understand the cause-and-effect relationships in critical risk scenarios and can identify risk metrics that would be valuable in effective risk management. Risk dashboards can also provide a way to monitor key metrics and trends.

## **MAKING THE CONNECTION**

Connecting strategy and enterprise risk management is critical for every company in its quest to create and protect shareholder value and corporate assets. Vigilance regarding forces of change means continuous strategic risk assessment and risk management that include managing both the upside and downside of risk. To be effective, risk assessment, risk management, and ERM should be embedded in strategic plans and budgets, execution plans, and performance measures. Using this approach can help management and boards protect corporate reputation, corporate integrity, and shareholder value. ■

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