

# How to see it coming: Linking risk and performance management

Get up to speed\*



# How to see it coming next time: Linking risk and performance management

Many companies use retrospective indicators, disparate systems and inefficient data-gathering processes to monitor their core business activities. So how can you get the information you need to make sound, risk-informed decisions?

How much do you really know about your business? In our previous point of view, we talked about the importance of making everyone personally accountable for risk. But you can't expect people to take the right decisions unless they have the right information – information that's both relevant and reliable.

Of course, most organisations collect an enormous amount of data. But extracting truly meaningful information from this morass of detail is often very difficult indeed. Technology research firm Gartner recently predicted that, between 2009 and 2012, more than 35% of the top 5,000 global companies will 'regularly fail to make insightful decisions about significant changes in their business and markets' because they lack the necessary information, processes and tools.

The problem is two-fold. First, much of the data companies collect is backward-looking.

But in order to manage risk properly, you have to see ahead. So you require information that give you clues about the future; like the anti-collision radar systems used in aircraft, it must warn you of danger *before* the danger materialises.

Second, that information must be accurate – and a robust technological infrastructure is essential here. Yet many organisations still rely on inefficient processes and disparate systems to capture the data they need. They supplement their existing infrastructure with isolated 'patches', as and when new compliance requirements surface – an approach that results in an increasingly hotchpotch IT environment.

So how can you create an information base that will give you the insights you need to see risks that are still on the horizon and respond to them appropriately?

## Highlights

1. **Identify what you really need to know:** Define your core business objectives and the main risks that could help or hinder you in achieving them.
2. **Choose the measures that matter most:** Look for indicators that can give you an idea of how these risks might affect your company's performance, if they occur. Be selective; a few key measures are far better than a long checklist.
3. **Turn your data into actionable information:** Standardise your management and reporting processes, make sure that you're fully utilising your existing systems and use middleware, if necessary, to integrate disparate data elements.
4. **Create a risk-informed organisation:** Use the information you now possess to monitor your operational and financial performance, identify any opportunities for improvement or growth, and infuse the organisation with a shared sense of responsibility for risk management.

# Understanding the links between risk and performance

- Risk is, by definition, forward-looking; it's a measure of the probability of loss or gain from a given event, and that probability of loss or gain directly affects a company's performance objectives. Yet many executives still see risk management and corporate performance management as quite separate activities.
- They focus on trying to avoid any repetition of known, historical business problems, rather than anticipating major changes. But risk management that's based on prevention rather than prediction fails to prepare a company for the future. It cannot, for example, take account of the sort of shifts that redefine an entire industry.
- In fact, risk management should be an integral part of a company's operational and financial performance management. And the measures the C-suite uses to manage risk should be closely connected with the measures it uses to manage the other elements of the company's performance.
- Unfortunately, however, this is much easier said than done. The overwhelming majority – 71% – of the senior executives we polled in one recent survey said that the biggest barrier they face in linking their risk and performance indicators is lack of reliable information.
- Why? A lot of companies have inefficient data-gathering processes; fragmented systems; and heterogeneous reporting structures, based on different reporting periods, data sources and reporting tools, which typically produce conflicting versions of the 'truth'.
- Many companies also implement risk management and compliance initiatives in response to a crisis or to meet a legal deadline, rather than treating them as an intrinsic part of their performance management processes. As a result, such projects are often conducted in isolation, without regard for the systems that are already in place. This ad hoc approach makes it very hard for management to get a coherent picture of what's happening throughout the entire enterprise.
- Conversely, adopting a holistic approach to risk management enables a company to understand the links between its risks and performance; to establish a meaningful set of measures – or risk-informed performance indicators, as we've called them – for monitoring its progress; and to make smarter management decisions.
- So how can you get the information you require to manage your risks and performance holistically? There are four key steps:
  - Identify what you really need to know
  - Choose the measures that matter most
  - Turn your data into actionable information; and
  - Create a risk-informed organisation.

# 1 Identify what you really need to know

- **Begin with the big picture.** All large organisations gather a huge amount of information, so the first task is to ascertain what you *really* need to know. Start by sitting down with your fellow executives and defining your business objectives – the key strategic, operational and financial goals you want to realise.
- **Look at the flipside.** Now identify the main risks that could either help or hinder you in achieving your objectives. These will obviously vary, depending on your company’s individual circumstances and the industry in which it’s operating. But suppose, for example, that it’s a components manufacturer. The main strategic risks it faces might include intense competition and the pace of innovation, while the main operational risks might include supply-chain disruptions and intellectual property theft, and the main financial risks soaring commodity prices and a large pension plan liability.
- **Assess the odds.** Once you’ve identified the key risks your business faces, you should assess how they would affect it, if they materialised. Consider both the size of each risk and its momentum; is it increasing, decreasing or stable? This will help you determine how likely it is to occur. It will also help you spot any potential conflicts of interest within the business. It’s only by aligning information about your objectives and risks that you can detect and resolve such competing objectives.
- **Keep track.** The next step is to devise a set of risk-informed metrics that will enable you to track your organisation’s performance and ensure that the decisions everyone makes are in line with the strategy you’ve established. We’ll talk more about this in the following section.

## Connecting the dots

When a leading Canadian utility set itself various core business objectives, the board recognised that the company couldn’t achieve its goals without considering the attendant risks. So it implemented a three-phase risk management programme, beginning with the development of a company-wide risk profile. This process showed that increased demand on the company’s aging infrastructure posed a significant risk to some of its core objectives: namely, to achieve a top-quartile performance in its transmission and distribution business, to achieve a top-quartile performance in terms of operational efficiency; and to satisfy 90% of its customers.

Acting on the insights it had gleaned from linking information about its risks with its goals, the company launched an energy conservation initiative that included providing customers with free real-time electricity monitors. As a result, it helped its customers reduce electricity consumption by up to 15%, thereby alleviating some of the burden on its assets and boosting its customer satisfaction ratings above 80%.

## 2 Choose the measures that matter most

- **Cut to the chase.** When it comes to developing the right risk-informed performance measures, a few essential metrics are far better than a cumbersome laundry list. So focus on the processes that offer the greatest opportunities for creating value or the greatest danger of destroying it.
- **Think big and small.** Don't concentrate exclusively on systemic, high-impact risks, though. Sometimes, a risk that initially seems quite trivial can escalate into a full-scale disaster.
- **Study the downside.** Ask yourself two key questions: What have I really got to lose? And how much shock can my balance sheet endure? Many companies don't quantify how much they're willing to lose, if a risky transaction goes sour, or how much money would be required to survive, if it turned into a worst-case scenario.
- **Cover all the bases.** But don't rely on financial measures alone. Operational measures are equally important.
- **Choose wisely.** Make sure that the metrics you select truly matter. A good risk-informed performance indicator is one that funnels a lot of information into a single, relatively simple measure; acts as an early warning sign; and affects the decisions management makes (see opposite).

### Setting the right business metrics

When you're deciding what to measure and how best to measure it, ask yourself the following questions:

1. **What are the greatest sources of value creation and destruction across our business?**
2. **Where have we failed to deliver value to our shareholders, and where have we succeeded?**
3. **How do we currently measure the potential effects of risk?**
4. **Do these measures provide a clear picture of the risk variables – i.e., the possibility that a risk will occur, the probability that it will occur, the time at which it is most likely to occur and the severity of the impact?**
5. **Are they quantifiable (in monetary terms, numbers or percentages), easy to understand and apply, timely and cost-effective?**
6. **Are they tailored to our company's specific objectives and the industry conditions in which it operates?**
7. **Can they be used to corroborate or invalidate management's decisions and actions?**
8. **Where is the underlying information kept? Does it reside at the business unit or functional level and, if so, is it readily accessible to the C-suite?**

### Survival of the fittest

One highly respected European car insurer combines financial and non-financial data in management reports, with information on sales. The common denominator isn't whether it's a financial or non-financial number, but whether it's a vital aspect of the company's performance. One of the top executives in the company also analyses three critical 'live-or-die' metrics every morning: loss ratios, expense ratios and ancillary sales. Rigorous use of leading risk indicators has helped the company more than double its revenues over the past six years<sup>1</sup>.

1. PricewaterhouseCoopers, 'Management Information and Performance: CFOs Face New Demands for High-Quality Data That Drives Decisions' (June 2007).

# 3 Turn your data into actionable information

- **Take stock.** Now that you've worked out what you need to know to manage risk properly, you can focus on getting it in as reliable a form as possible. This doesn't necessarily mean that you'll have to overhaul your entire IT infrastructure. Many companies already collect the information they require; the trouble is that it's buried in numerous different data systems and silos scattered throughout the organisation – or even outside it. Investment decisions are often based on information about the economic climate and market conditions, for example, as well as information about a company's financial strength, production plans and so forth. So take stock. Assess the quality of the

data you gather against five key criteria: correctness, credibility, consistency, currency and completeness (see Figure 1).

- **Lay down the rules.** Most large companies have standardised operational processes. Ensure that your management and reporting processes are also standardised.
- **Make the most of what you've got.** Ensure, too, that you are exploiting the full capabilities of the technology you already possess. According to one study, companies typically utilise only 27.6% of the functionality of their enterprise resource planning systems.
- **Be pragmatic.** Remember that you don't have to integrate every application. In fact,

sometimes it's too expensive to do so. Where this is the case, think about putting a monitoring and reporting application on top of your other applications to pull together the information they hold. In other words, use middleware to integrate your information rather than trying to integrate the applications that contain it.

- **Manage the change.** Make sure that all the people who are involved in gathering the information you need understand how that information will be used, as well as how to operate any new systems, software and processes you introduce.
- **Hold onto the reins.** Establish a consistent, enterprise-wide set of standards for investing in new systems and applications. If your business units buy software independently of the organisation as a whole, there's a danger that they'll create new information silos, thereby limiting the ability to perform cross-functional analyses and reducing the value of the investment you've made.
- **Learn as you go.** Set up a system for continuously monitoring and refining the tools and processes you use to collect the information you need.

Figure 1: The five 'Cs' of data quality

Correct	The data are accurate and reliable. They have been validated using an independent source of information that is known to be correct.
Credible	The data are believable and 'reasonable' – e.g., the number of products sold at each site does not exceed the number of products sold by the entire company.
Consistent	The data are clear, unambiguous and consistent – both within the same database and across different databases.
Current	The data are up-to-date and available in a timely manner.
Complete	The data are comprehensive. No records are missing and every field is known for each record.

Source: PricewaterhouseCoopers

# 4 Create a risk-informed organisation

- **Make smarter management decisions.** You've finally got the information you need, so how should you use it? First, and most obviously, to monitor your organisation's progress and make smarter management decisions. Armed with an accurate picture of how the risks it's assuming – or avoiding – are affecting its operational and financial performance, you'll have a much better idea of which levers to pull and when to pull them.
- **Go for the gold.** You can also identify any areas for improvement and assess the opportunities for growth much more accurately – both factors that can make a big difference to your bottom line. Neil Doherty, chairman of the Insurance and Risk Management Department at the Wharton School in Philadelphia, estimates that a 'sophisticated and comprehensive' approach to risk management, in which risk is viewed as an integral part of financial management, can increase a company's value by 3-5%.
- **Convert the crowd.** These are by no means the only ways in which you should use the information you've acquired. Recent events have clearly demonstrated that separating a company's risk management from its financial and operational management is a recipe for disaster. In an increasingly connected world, it's essential to integrate them and adopt a collaborative approach. But people do what they get measured on, so risk-informed performance indicators are crucial in creating a culture of individual and collective accountability for risk management.
- **Pay as they perform.** The way employees are remunerated also shapes how they behave – and risk-informed performance indicators are invaluable here, too. Once the links between risk management and performance are visible, you can devise incentives that are aligned with your organisation's risk appetite and long-term profitability; and pay people according to their risk-adjusted performance. In fact, some companies have even introduced claw-back schemes, where senior executives are required to repay any bonuses based on performance claims that later prove erroneous.

## Reward for taking the right risks

The engineers at a company that builds and maintains nuclear plants had never been conditioned to take business risks: quite the contrary, indeed. But when the company started facing pressure to grow through new business ventures, new markets and new technologies, the board decided to introduce an incentive scheme aligned with smart, performance-based risk taking.

The board started by freeing up a core group of senior managers to pursue new business ideas and innovations, and teaming them with efficiency experts to create a set of metrics that rigorously accounted for the upside – and downside – potential of each project. All managers are now evaluated on criteria linked with the company's risk and performance management strategy, such as the number of customer calls and sales proposals they make. To date, the programme has helped the organisation move into two new growth areas.

# Incorporating risk indicators into established performance management processes is essential to facilitate well-informed decision making

- Think of risk management as a normal management process, not a separate activity.
- Assess how clear a picture you have of the overall risks your organisation is taking.
- Focus on developing a few crucial measures with which you can track the risks to your most important processes.
- Ask yourself what you don't know. Are there any risks you haven't even considered?
- Gauge the quality of the information you collect. Consider using reporting software to integrate data from disparate sources.
- Keep a close eye on your bill for risk management and compliance. Investigate, if it suddenly starts soaring.

# How PwC can help

PricewaterhouseCoopers works to solve complex business issues – locally and globally. Our teams draw upon skills in risk, regulation, people, operations and technology to capture opportunities, navigate risk and deliver lasting change across business networks.

We have advised many companies on how to build a risk management infrastructure that is fully integrated with their performance management systems. We can help you to:

- Identify and assess the risks that could either help or hinder you most in achieving your objectives.
- Link your risks with your performance by turning your data into actionable information and defining risk-informed metrics to track your organisation's performance.
- Assess your existing risk management infrastructure and identify any shortcomings.
- Develop a holistic IT strategy that treats risk management and compliance as an integral part of your core performance management systems.
- Make the most of the systems and applications you currently use.
- Research new tools for integrating your management and operational data, and select the best solution for your needs.
- Create a sustainable technological platform in which risk management and compliance are embedded in the systems and processes you use for running your business on a day-to-day basis.

If you would like to discuss how to use technology to manage risk and compliance holistically, please contact one of our partners (whose details are listed on the next page) or visit [www.pwc.com/getuptospeed](http://www.pwc.com/getuptospeed)

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## Get up to speed\*

Other topics in this series:

### **Crisis management**

An unanticipated crisis can cause immense disruption, cost a lot of money to rectify and damage your company's image if you end up on the front page of the newspapers. This paper examines how companies can take sensible precautions, recover control and extract value from the situation.

### **Risk appetite**

Most risk management systems aim to avoid risk. But if a business doesn't take risks, it can't grow. This paper looks at how you can make risk work for you and how to take the right risks and manage them successfully.

### **Risk culture**

Establishing a culture in which the right people do the right thing at the right time, regardless of the circumstances, is critical to an organisation's ability to seize the right risks and avoid the wrong ones. This paper explains organisational culture, how it can support your business strategy, goals and risk appetite and how important it is to get this balance right.

### **Operationalising risk management**

Most companies have responded to more regulation and increasing scrutiny from stakeholders by establishing independent oversight functions and additional layers of control. This paper looks at the steps you can take to make risk management and compliance a part of your day-to-day business, and reduce unnecessary overheads while at the same time adding value to your organisation.

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