< INTEGRATING > governance risk AND reporting TO CREATE < LONG-TERM VALUE >

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Organizations face more threats than ever to achieving their strategic objectives. These business risks emanate partly from increasing interdependencies with other organizations, such as alliances, as well as from global competition, changing technology, and ever-shortening product life cycles. In addition, stakeholders are placing increased pressure on companies to report successes and failures in managing these risks, especially when the company doesn't meet stakeholder expectations regarding performance.

Managing these risks successfully and reporting transparently on their progress to various stakeholder groups require the integration of three traditionally disparate topics—corporate governance, enterprise risk management (ERM), and business reporting. Organizations must consistently strive for integrity in governance, leadership in risk management, and transparency in business reporting. We'll discuss the value in integrating the three areas.

Boards and executives who are more interested in generating quick returns, meeting the current quarter's earnings expectations, or identifying a potential acquiring firm might not be overly interested in deriving the long-term benefits of integrating corporate governance, risk management, and business reporting. But those who are charged with increasing long-horizon shareholder value need to understand that organizations today are vulnerable at many internal contact points. Further, companies have an increasingly shorter time period for reacting to changes in the business environment, including those changes that impact their business directly or indirectly. We'll focus on how organizations that emphasize sustaining growth over the long term can benefit from integrating corporate governance, risk management, and business reporting.

THE CURRENT STATE

As codirectors of Miami University's Center for Business Excellence, we've talked with more than 400 individuals from more than 100 organizations over the past two years via site visits, research projects, Center conferences, and other activities. These organizations range from the largest of the *Fortune* 500 to midsize organizations to small start-up firms. Several important observations have emerged. First, we have yet to encounter an organization that isn't interested in improving some aspect of its corporate governance structure, risk management across the enterprise, or internal or external business reporting. Further, most organizations with which we've interacted want to find ways to better integrate across these topics. We'll now share insights from our interactions.

Governance

Increasing threats, such as expanded global competition, business and transaction complexity, and stakeholder expectations, have elevated the importance for sound corporate governance and a need to understand from a top-down perspective how organizations are structured and operated in order to manage risks to their desired risk appetites. Interestingly, there's a wide variety of approaches for designing governance structures. Within the governance structure, enterprise-wide strategies assess and measure risks, optimize risks that present opportunities for desired returns, mitigate other risks, and report risk information inside and outside the organization.

The structure of risk management and the lines of risk management reporting—key components of governance—vary widely. Some organizations structure risk management so that executives who own the process, often titled the chief risk officer, report directly and frequently to the board, while other organizations structure risk management so that executives who own the process report to the board's risk committee—or even an executive risk committee—on a nonsystematic basis. A key determination in how organizations implement governance mechanisms to manage risk is the extent to which they have linked risk management to the organization's mission and strategies. Those that have linked strategy and risk management are more likely to have corporate governance processes in place that provide sufficient risk management oversight. One example of how this oversight works well is by having an executive risk committee that meets periodically throughout the year and provides routine updates on risk management issues to the full board of directors or one of its committees.

Risk Management

The size and composition of the risk management function also vary widely. Some organizations have many individuals responsible for risk management, but others might have only a few, instead relying on operating personnel to play a key role in the risk management and reporting function. In addition, how businesses choose to represent their risk management function varies across organizations and industries.

The basic difference is whether they view risks on a qualitative or quantitative basis. Financial services institutions, which have a rich history in modeling product, credit, and market risks, tend to measure risks quantitatively, even representing them in specific measures such as economic capital or value-at-risk. Organizations that primarily model operational risks and include many nonfinancial measures often implement risk management frameworks that use more qualitative metrics (such as red vs. yellow vs. green lights). Regardless of how sophisticated the mechanism for managing risks, the prevailing challenge remains correlating and managing interrelated risks.

Business Reporting

The reporting of risk-related information and risk management processes is the most widely varied of the three areas, probably because most organizations don't integrate their reporting regarding issues of interest to stakeholders (i.e., risks) with their formal governance or risk management practices. The current reporting vehicle appears under a variety of names, including corporate sustainability, corporate responsibility, triple-bottom-line, citizenship, etc. (we will refer to them collectively as CSRs). A CSR is really nothing more than a report on risk management for a subset of the organization's business risks that impact external stakeholders. Until companies can better link such risk management reporting to governance and risk management, it's unlikely that this reporting vehicle can realize its full potential.

More than 2,500 organizations worldwide issue CSRs, but they vary widely in three ways:

- **Form—**Some reports follow optional formal guidelines such as the Global Reporting Initiative or the Dow Jones Sustainability Index, but others don't;
- **Content—**Reports vary from two to more than 200 pages in length; and
- **Degree of Credibility—**Some reports provide external assurance, either by auditors or panels of experts, while others don't.

THE NEED TO INTEGRATE

Overall, organizations appear to differ greatly in their levels of emphasis on corporate governance, risk management, and business reporting, depending on conditions surrounding the organization or its industry. There are varied levels of emphasis when a company views each topic as a silo. For example, organizations tend to emphasize governance if they have prestigious board members who are in high demand because the financial press often analyzes them more thoroughly.

Another observation is that organizations within regulated industries typically have more sophisticated processes for risk management than those in unregulated industries. Since the Federal Reserve Bank evaluates member banks on ERM effectiveness, and A.M. Best and Standard & Poor's evaluate insurance companies for ERM effectiveness, they understandably are focused on developing effective processes. Broad-reaching impacts from poor risk management, evidenced in today's marketplace by the fallout associated with the subprime lending crisis, suggest that the movement toward rating organizations on their risk management effectiveness is likely to move even faster than previously expected.

Conversely, organizations that face high levels of media scrutiny for alleged actions that negatively impact stakeholders (employees, customers, etc.) typically have more sophisticated processes for monitoring and reporting how effective they are at managing such particular risks (e.g., death or injury of workers in plants or agricultural fields around the world operated by alliance partners). Reporting often involves issuing CSRs, but nearly all such CSRs fail to clearly link the risks in the report to the organization's formal risk-management processes. One reason is that some organizations that issue corporate sustainability reports simply don't possess formal ERM processes. Yet they have recently begun to implement a formal ERM practice, especially in light of the Sarbanes-Oxley Act. Perhaps even more importantly, for those organizations that *do* link their sustainability reporting and risk management processes, very few specifically link their risk management processes to their strategic decision-making process, which we believe is critical for long-term organizational success.

THE VALUE OF INTEGRATION

Regardless of the mechanism in place for integrating corporate governance, risk management, and business reporting, the most significant challenge most organizations face is designing an effective, integrated process and then properly equipping managers charged with understanding, measuring, and communicating risk information. Leaders in these areas have told us that, at a minimum, organizations need to commit to demonstrating integrity in corporate governance, using strong leadership when designing risk management processes, and

Table 1: Executive and Board Member Responses

How would you describe the level of implementation of your organization's risk management process from 1 (not implemented) to 5 (fully implemented)?
Mean Response = 3.28
How would you describe the role of sustainability and corporate responsibility in your organization's overall strategy from 1 (not part of strategy) to 5 (integral part of strategy)?
Mean Response = 2.56
How would you describe the level of implementation of your organization's process for transparent business reporting from 1 (not implemented) to 5 (fully implemented)?
Mean Response = 3.38
My organization would benefit from more strongly integrating corporate governance, risk management, and transparent business reporting from 1 (strongly disagree) to 5 (strongly agree).
Mean Response = 4.27

striving for transparency across the organization when reporting on business activities.

For example, during a recent visit to Miami University, Judge Sven Holmes, executive vice chair of legal and compliance at KPMG LLP, told students taking a course on these concepts: "Governance, risk management, and transparent reporting are key fundamentals for sustained business performance." He spoke from personal experience. Before joining KPMG LLP in 2005 to help the firm improve in these three areas, Holmes spent 10 years as a United States District Judge for the Northern District of Oklahoma, including two years as Chief Judge. His efforts to improve the integration of these concepts were instrumental in helping KPMG work with the Department of Justice, clients of the firm, 20,000 KPMG professionals, and the public to successfully emerge from its tax shelter crisis in 2005. Because of his leadership and KPMG's commitment to improve and integrate these processes across the firm, it emerged stronger by repairing—and even strengthening—its relationships with key stakeholders

Several observations and experiences illustrate the value of linking these three areas. For example, a survey offers insight from more than 70 executives and board members who attended Miami University's 2006 and 2007 executive conferences on governance, risk management, and reporting. These respondents represent various-sized public and private organizations in a wide range of industries. Table 1 provides the mean responses for several questions. Overall, organizations appear to be actively implementing independent processes for the three areas, but there seems to be consistent support for improving these processes and their integration. In addition, one conference attendee noted that training in integrated governance, risk management, and reporting is needed at the bachelor's and MBA degree levels.

Many, if not all, reputable frameworks for enterprise risk management, including the one issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), *Enterprise Risk Management—Integrated Framework*, emphasize that ERM is destined to fail without senior management owning it and the board properly overseeing it. Indeed, many organizations are forming separate risk committees under the board, and most board committee charters place strategic, operational, reporting, and compliance risks as the responsibility of one or more board committees.

The governance aspect of this linkage focuses primarily on the roles of the board and senior managers as stewards of investor capital and other stakeholder investments in the organization, such as employee and customer loyalty, community dependence, alliance partner strategic/operational objectives, regulator reputations, and the like. Those individuals charged with governance will probably continue to face many challenges in effectively carrying out their fiduciary duties for investors. One consistent theme in today's interconnected information age, however, is that a failure to manage stakeholders' concerns both collectively and individually can have negative impacts on investors through declines (or insufficient gains) in shareholder value. Dedicated actions by concerned stakeholders, such as new regulations addressing pollutants or refusals by customers to buy from suppliers with human rights abuses, can cause declines if they don't perceive that the company is addressing their concerns seriously.

A critical challenge then is developing the best strategy to inform investors and other stakeholders accurately and on a timely basis regarding the organization's management of risks that threaten achievement of its strategic objectives. Although not yet performed effectively, organizations worldwide are adopting—at an exponential rate—

Table 2: Important Issues for Properly Integrating Corporate Governance, Risk Management, and Business Reporting

Ensuring Proper Governance over Risk Management and Reporting
Boards need to assume proper oversight and ensure that proper structures are in place at organizations for effectively managing risks and reporting on risk management effectiveness to internal and external stakeholders.

Developing a Common Risk Language—Breaking Down Organizational Silos
To better communicate within the organization and across organizations, a common terminology should be used regarding the basics of risk management and how the organization can evolve to an enterprise view of risk management.

Linking Risk to Strategy—Risk Appetite and a Portfolio View of Risk Optimization
Organizations need to develop an overall risk appetite consistent with the returns being sought by senior management, shareholders, and other key stakeholders. Using a portfolio risk management approach can help them seek risk opportunities and mitigate risks where appropriate.

Implementing Steps of Risk Assessment and their Relation to Common Frameworks
Regardless of the framework employed, the basic steps associated with assessing risk within most risk management frameworks are fairly similar: understanding risk sources, evaluating probabilities of risk events and their impacts, and prioritizing risks based on the outcome of inherent risk assessment.

Responding to Risk—Choices and Impacts on Other Risks
Organizations need to gain an appreciation for the core challenge associated with risk management when deciding how to respond to risks using a portfolio view of risk management. Such impacts can help further mitigate other risks or increase risk probabilities or impacts (e.g., reducing production costs through international outsourcing increases the risks of quality defects—lead paint used in toys, contaminants in food products, etc.).

Measuring Risk Responses, Residual Risk, and Impact on Performance
Measuring risk response is perhaps the most advanced aspect of risk management. For risk management to reach its full potential with organizations, a clear link between efforts to respond to risk and residual risk to organizational performance is necessary.

Reporting Risk Management Information to Internal Stakeholders
There are several mechanisms for assessing and communicating risk exposures and the outcomes of risk responses within organizations, including evaluating the effectiveness of risk assessment and risk responses and determining whether the process has helped improve the chances of achieving strategic objectives.

Understanding External Demand for Risk Management Information
Many organizations focus on the evolving practice of stakeholder engagement in which organizations improve their risk management processes by understanding stakeholders' concerns and effective ways to communicate their responses to those concerns.

Reporting Risk Management Information to External Stakeholders
Utilizing stakeholder engagement and transparent business reporting to communicate to stakeholders the extent to which the organization is optimizing risk in a manner consistent with its risk appetite should lead to aligning with stakeholders that share similar risk appetites over the long horizon.

transparent reporting of how they manage risks that affect stakeholders. As we mentioned earlier, one major indication of this pattern is that, as of 2007, more than 2,500 organizations worldwide issued corporate sustainability reports. A not-for-profit organization, the Global Reporting Initiative (GRI) creates the most widely adopted set of guidelines for preparing CSR reports, including its most recent G3 guidelines that it hopes attain the status of "generally accepted" for CSR reporting. GRI indicates that more than 2,400 organizations prepare CSR reports that adhere to its guidelines in some capacity.

Such exponential growth in CSRs over the past five years is consistent with a general movement toward greater transparency on the part of organizations worldwide. Jeff Immelt, CEO of General Electric, told us he is firmly committed to enhancing GE's transparent reporting of issues that affect stakeholders going forward as a key element of its reporting process. Other organizations have continued to evolve their stakeholder reporting to help address the key concerns of stakeholders, including investors. For example, the major petroleum companies have implemented stakeholder interaction practices. In addition, some companies, such as Royal Dutch Shell, have begun using external expert panels as their assurance mechanism for their CSRs. Robert Herz, Financial Accounting Standards Board (FASB) chairman, told us that while enhanced business reporting isn't currently on the Board's agenda, he is personally interested in the growing trend of sustainability reporting and believes that Europe is much further ahead in this area than the United States. To address this issue, organizational partners including the American Institute of Certified Public Accountants (AICPA), Grant Thornton, PricewaterhouseCoopers, and Microsoft formed the Enhanced Business Reporting Consortium in 2005 to see whether the increasing stakeholder demand for reporting nonfinancial business measures might help evolve financial reporting to business reporting.

CREATING THE RIGHT CULTURE

To integrate governance, risk management, and reporting means creating an organizational culture that is committed to doing so. This culture creation will take a sustained investment and patience to develop. Table 2 lists issues that most organizations need to address at a minimum to move to an integrated governance, risk management, and reporting environment. With senior management ownership and sufficient board oversight, organizations can address these issues and strive to attain the competitive advantages associated with a proactive, rather than reactive, approach to understanding stakeholder expectations, changes in the business environment, and internal and external forces that impact an organization's ability to achieve its strategies and mission.

Enterprises are beginning to move toward integrating their risk management and business-reporting processes. This move is particularly evident in Europe where the link between risk management and corporate responsibility has led some organizations, such as Novo Nordisk, to issue one combined annual report that includes both the financial statements and key elements of a typical CSR report rather than a traditional annual report and a standalone CSR report. In the U.S., PepsiCo has also begun this process. As another example, American Electric Power, one of the largest electric utilities in the U.S., has integrated its risk management and CSR processes.

TAP POTENTIAL TO INCREASE SHAREHOLDER VALUE

Integrating corporate governance, risk management, and business reporting is growing in importance because of the increasing number of risks organizations face that threaten their strategic objectives. Boards and senior executives need to assume oversight and ownership roles, respectively, to establish processes to ensure that their organizations are appropriately identifying and managing risks on a portfolio basis. Further, companies need to identify the most appropriate process for determining not only what information they should report to internal and external stakeholders, but to what extent, which is important for ensuring that the organization is demonstrating leadership. Organizations will fully recognize their potential for increasing long-term shareholder value only by integrating the three key areas of corporate governance, enterprise risk management, and transparent business reporting. ■

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Risk management is a topic at IMA's Annual Conference, June 14-18, 2008, in Tampa, Fla. For information, visit www.imaconference.org.