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Integrating risk and performance in management reporting

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Key findings:

- Risk and performance are related, but the combination of risk and performance information into a single instrument is not always the most feasible solution to reach alignment.
- The way in which risk is related to performance management is based around a variety of organisational elements that may inhibit or conversely facilitate the integration of risk and performance management processes. For instance:
 - The presence of a different periodicity of risk and performance reporting may limit their integration.
 - The presence of a clear cut strategy that serves as a reference point for both risk and performance targets may foster alignment.
- Risk is often implicitly related to performance management. Performance management tools can provide risk information without much additional efforts. For instance:
 - Performance reports can contribute to develop an awareness of emergent issues by highlighting performances that are changing unexpectedly.
 - In certain areas, for example Health and Safety (H&S), KPIs can become good measures around risk. Trends in the number of incidents (or near misses) can be analysed to understand whether the business is becoming more or less risky.

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Introduction

The recent economic crisis has focused attention on risk management, but managing risk is all about achieving objectives (Woods et al. 2008; Cotter, 2009; Van der Stede, 2009). Senior managers in particular, are expected to build sustainable performances: create value at acceptable risk levels over time (Calandro and Lane, 2006). To this end, they should be clearly aware of the multiple sources and types of risks (CIMA, 2007). A stronger focus on risk in performance reports addressed to senior managers can address such expectation. Incorporating risk into performance management processes can foster a better understanding of the overall organisational risk exposure and improve business results.

The way in which senior managers are made aware of risks via top management reporting is however an open ground where different professions and processes may find a role. On the one hand, the reporting of high level risk information is considered a constituent element of enterprise-wide risk management (ERM) frameworks. This attempts to provide an overview of crucial business risks, integrating traditional, function-specific risk management efforts, for example labour safety and information

system security. This reporting can include a range of different information (Lam, 2006): qualitative information such as objectives at risk, audit findings and escalation of particular events or quantitative data such as early warning indicators, key risk indicators (KRIs) and financial risk measures, for example value at risk (VaR).

On the other hand, it is argued that innovative performance management frameworks may contribute to foster senior managers' ability to oversee business risks (IMA, 2006). In fact, frameworks such as the Balanced Scorecard (BSC) try to overcome the shortcomings of traditional accounting indicators by means of a balanced set of non-financial performance measures. This allows an early detection of weak signals from the environment and provide a more timely and long-term oriented view of the business (Kaplan and Norton, 1992, 1996, 2001). The use of such frameworks can help signal that some risks related to an item exist and will eventually cause poor financial performances.

This project aims at providing some insights on how it is possible to link risk to performance management via top management reporting. Specifically, the project examines how:

1. Risk-related information are reported to senior managers.
2. Risk-related information are linked to performance management.

Research method

The research is based on a case study on one large UK energy company (hereafter: Energy Company). Background information on the Energy Company is presented in Table 1.

Table 1

Energy Company - background information	
Industry sector	Energy
Ownership	Wholly-owned subsidiary
Employees	More than 10,000
Structure	Four Business Units (BUs) Corporate and steering functions (HR, strategy and regulation, finance), corporate shared services (IT, procurement, project management)
Governance	<ul style="list-style-type: none">• The board of directors is composed by two executive directors and four non-executive directors and a company secretary• An executive committee, composed by the chief executive, chief financial officer, the BUs managing directors and corporate and steering functions (HR, strategy and regulation)

Table 2

Job title	Responsibilities
Corporate risk director	Responsible for the risk management process (company-wide level)
Performance manager (corporate function)	Responsible for company performance reporting (company-wide level) Local risk co-ordinator (corporate functions and shared services)
Internal audit manager (business unit)	Contribute to internal audit processes (business unit level)
Risk and compliance manager	Compliance with regulatory conditions Contributing to the development of departmental audits and maintenance of local risk register (business unit level)

The case study is based on documentary information (including internal reports and guidelines on risk management) and a set of face to face interviews. Key informants of the case study are managers responsible for the reporting of performance information and managers responsible for the risk management process at different organisational levels (see Table 2).

Interviews were based on a framework that was made available to interviewees beforehand. The structure of all interviews is similar, although adjustments are made according to the specific role of each interviewee. An outline of the main points discussed through interviews is presented in the appendix.

The case study

The Energy Company has a central risk management policy that describes the minimum risk management standards that Business Units (BUs) have to comply with. Risks are scored using a standard template that is based on a one to five impact scale. Descriptions are provided to help people identify a consistent score, especially for non-financial risks such as customer, safety, staff and reputation and so on. Specific methodologies are not mandated to score risks. BUs are free to choose the most appropriate approach for the risks they are managing. Generally speaking, BUs can have their own risk management policy as long as they remain aligned with central requirements. The approaches adopted across the company range from stochastic modelling to subjective judgement and experience. Workshops are used to facilitate the risk management process. They typically start with the identification of organisational objectives and continue with a brainstorming exercise on the possible risks that may affect their achievement.

A corporate risk director, supported by a central team (hereafter: central risk team), is responsible for the risk management process, while BUs' senior managers are accountable for the

actual management of risks in accordance to the central risk management policy. BUs collect key risks data and put together a report with the support of local risk teams. Local risk teams report quarterly to the corporate risk director, who then reports to the executive committee.

At the BU level, the composition of local risk teams and the job description of their members can vary across different BUs and departments, which are BUs' sub-organisational units. For instance, in one BU there is a senior person who is nominated to be responsible for risk reporting in each department. They are supported by a subordinate who is responsible for maintaining each area's risk function. Different arrangements are possible in different departments. For instance, in one department a role has been created with specific responsibilities including compliance with the regulatory conditions, support to departmental audits and maintenance of risk registers. In other departments the responsibility to maintain the risk management process may not be so apparent or it may be characterised by different elements, for example a greater emphasis on business continuity. A team of two people (local risk team) co-ordinates and steers all risk management efforts within BU four. From each department, the local risk team receives a quarterly risk management review, aggregates the information and reports to the BU executive committee, before reporting to the central risk team.

In addition, a local risk 'champion' who is usually part of local risk teams, supports and promotes the risk management process in the BUs, making sure that people are collecting risk information properly. The corporate risk director meets formally with the risk champions at least once every other month. Furthermore, when the quarterly reporting cycle of risk information is closed, the corporate risk director has a post report meeting with local risk champions. In this meeting, the

corporate risk director explains what has been discussed at the board level and how the risk management process has been run for the quarter. Issues typically discussed are timeliness of the delivery of reports, implementation of action plans, and the escalation of specific trends. The work of risk champions in the company varies across different BUs. For instance, the risk champion of the corporate functions and shared services unit aims at making people use the risk register practically through engagement. He works with senior managers to make sure that risks reflect their personal objectives and that action plans reflect the work that they are doing against risks.

In general, risk champions have an oversight of the risk register of all the senior managers of the BU. This facilitates the risk management process because it allows to point out connected elements; for example audit, governance and assurance, and to calibrate risk assessment and mitigation strategies. Each risk register can be linked, although in most cases not explicitly, to a list of KRIs, which are simply function-related KPIs. For instance, for the media team of the corporate functions and shared services the number of negative stories that appear on the media could be one of the indicators used. In general, KRIs can be used to assess how well risks have been managed and they can become a more assured way of scoring risks.

Performance management in the company is based on an adapted version of the balanced scorecard methodology. Performance management is initiated by a company scorecard, which is then cascaded down by means of operational scorecards at the BUs' level. The company scorecard constitutes the corporate-wide strategic reference framework for decision making. It illustrates a set of ambitions that cover strategic areas such as people, financial, H&S and so on. These ambitions are equally rated and are associated to a limited set of financial and non-financial KPIs. BUs scorecards aim at linking company's ambitions to each business area by means of a larger number of measures that are more closely associated with operational effectiveness at a daily management level. Bonus schemes are structured around the same performance metrics used in the reports so to reach alignment between individual and company's performance.

The company has a monthly performance report which summarises information for the whole business, followed by a monthly report for each BU and the corporate functions and shared services unit. The company report has a section on how the risk management process is run, but risks and risk measures are not formally incorporated at this level. Risk information can occasionally be incorporated into performance reports at lower organisational levels. For instance, the report for the corporate functions and shared services unit has a section that include

a dashboard of KRIs. The report of one department of BU four incorporates the departmental risk map, the trends of risk indicators and information on risk mitigation strategies.

In general, it is acknowledged that the company is a big business and mapping a direct relationship between risk and performance measures can be tricky, since many risks are over a longer-term horizon. However, this does not mean that performance management does not consider risks. For instance, the team that reports to the executives company-wide performance information (performance team) focuses on developing an awareness of the key areas and developing trends by looking at where new risks are emerging or performances are changing unexpectedly. There are no pre-defined thresholds to determine when a further examination of performance is needed. The team investigates measures that are persistently below target, but also measures that are constantly above target. This latter case might suggest that targets are set too tightly or too loosely or risks are poorly understood. Performance management can also provide a source of quantitative information for risk management via performance indicators. In certain areas most of the KPIs can become good measures around risk. For instance, in the H&S area the company records the number and the types of operational incidents, or near misses (incidents that could have potentially happened), that have occurred in a given period. These evidences are reviewed monthly by all the heads of H&S units in the company. This can be considered as a form of quantified risk assessment based on real evidence. Trends in the number of incidents, or near misses, are analysed to understand whether the business is becoming more or less risky.

Main findings

A general finding of this research is that incorporating risk into performance management is not simply an issue of combining risk and performance information into the same report. This finding can be more relevant than its apparent simplicity might suggest. As a matter of fact, practitioner-oriented contributions (e.g. Scholey, 2006; Beasley et al. 2006) suggest that the combination of risk and performance information into a single management tool, such as a risk BSC, can be a solution to increase the risk awareness of senior managers. The evidence of the case study calls for caution to be taken when considering this claim. The company has an enterprise-wide approach to risk management and a BSC approach to performance management, but information from the former; for example impact/probabilities matrices, risk registers and KRIs, is incorporated into performance reports only at lower organisational levels. The business is simply too complex to combine company-wide risk and performance information in the same document.

However, risk and performance are related and the relationship between them is based around different organisational elements. These elements can be grouped in three clusters: barriers that hamper integrating risk and performance, facilitators that help overcome barriers, and levers which consist of performance management tools that if used in a particular way, can provide risk-related information. These organisational elements are described in the following paragraphs with examples on how they practically affect linking risk to performance management in the case study.

Barriers

The first barrier concerns the relationship between risk and performance. Informants in the case study suggest there is a tension in the relationship between risk and performance. The same element can be interpreted in different ways if a risk perspective or a performance perspective is embraced. An indicative example is provided by the different approaches that can be embraced in the analysis of results that exceed expectations. A performance based approach may suggest that results exceeding expectations is a positive signal as the organisation is over performing targets. A risk based approach might instead suggest being more cautious as results well beyond expectations might be a hint of a problematic situation. This possibly has problematic consequences in the future (see section on the levers for a more detailed explanation on the approach of the company related this issue).

The second barrier relates to the different time frame of risk and performance management processes. The evidence of the case study suggests that risk and performance management are likely to focus on different time horizons. In general, it is argued that risk management, especially an enterprise-wide approach, draws attention to strategic, longer-term risks, while performance management focuses on shorter-term issues. In the Energy Company this is reflected in the different periodicity of risk and performance reporting. The first is quarterly, whilst the second is monthly. There might be different rationales behind the choice to adopt a different periodicity in the two lines of reporting; for example historical reasons, time and resources constraints, regulatory and governance requirements. Yet, the main argument that emerged from interviews is the difficulty to capture risk information, or changes in risk information, over a short-term period. It is argued that risks can be captured only over a longer time frame (e.g. how a change in the production capacity for instance, the construction of a new power plant, might affect the company's competitive position); events that increase/decrease the risk exposure of a company often occur on a discontinued basis (e.g. major incidents or changes in regulatory conditions).

Facilitators

The case study suggests there are some elements that can facilitate reaching alignment between risk and performance management. The first relates to the development and communication of a clear-cut strategy, the second concerns the role embraced by actors that locally support and promote the risk management process (risk champions).

- **Strategy**

If risk and performance metrics relate to the same set of common strategic objectives, they are more likely to be aligned. For instance, in the company the strategic ambition 'zero harm' serves as a reference point for both risk and performance target, which fosters alignment. Even if individual measures for a year may not be explicitly related to the risk register, the strategic ambition makes clear the company's risk appetite when setting and evaluating performance targets. For example, actions that might lead to greater profitability, but increase the likelihood of harmful consequences should not be taken.

- **Risk champions**

In the company each senior manager has to keep a risk register that contains key risks and controls put in place. As risk is embedded in any type of activity, the risk register can be a useful starting point for managing activities. Yet, this can be facilitated by having someone that challenges managers to practically use risk register. Within each BU in the company this responsibility is assigned to risk champions, who help people to manage their risks. Furthermore, risk champions keep track of the key risks of a wide range of senior managers (ideally all senior managers that belong to the same BU). This helps them to articulate and calibrate individual risks for different activities.

Levers

The case reveals there are certain performance management tools that, if used in a particular way, can provide risk-related information. Their use can be leveraged to reach alignment between risk and performance management.

- **Key performance indicators**

Non-financial metrics can become useful risk indicators. This emerged looking at the company both from a risk perspective and a performance perspective. On the one hand, local risk 'champions' use KRIs to calibrate risk assessment and mitigation strategies. On the other hand, the team in charge of company-wide performance reporting analyses anomalies in the trends of KPIs to find evidence of potential risks that might impinge on the company's activities. In both cases, it emerged how

thinking in terms of processes might help identify good risk indicators, as risks are intrinsically part of what people do. KRIs are simply defined as function-related KPIs. As safety is a primary issue, an indicative example for the company is the use of records on the number and the types of incidents. These records provide a basis for a quantitative risk assessment on business processes. Another example that relates to a different setting is the number of negative stories for the media team that can be used to assess reputational risks.

- **Variance analysis.**

The analysis of variances between results and expected targets can become an excellent source of risk information, as it helps shed light on performances that are changing unexpectedly. Variance analysis is certainly not a novelty for managerial control. However, it emerges from the case study the distinctive role that variance analysis can play for risk management. In fact, in a traditional management by exception approach variance analysis is made between actual results and expected targets and negative variances are primarily investigated. Embracing this approach, companies tend to direct attention primarily to areas of underperformance relative to target and assume that all is well where and when performance meets or beats expectations. In the Energy Company, the performance team instead examines variances when actual results are too distant from targets (both below or above) to verify if targets are set too tightly or too loosely or risks are poorly understood. It is interesting to note that performances both above and below target are investigated, so to reach a healthy scrutiny of actual performances in expansion periods. This suggests that variance analysis can be used not only to identify performance problems, but also the emergence of possible risky situations, for example targets are misspecified or positive performances are occurring at the expense of something else, that might result detrimentally to the long-term profitability of a company.

Conclusion

The findings of this project are based on data from a single company that operates in the energy sector. The focus on a single company certainly does not allow any generalisation of the results. Bearing in mind such limitation, it is acknowledged that the findings are not directly extendable elsewhere. Nevertheless, this research has some implications for practical application. Specifically, it suggests that the combination of risk and performance information into a single report is not always the most feasible solution to reach alignment between risk and performance management, especially for complex businesses. However, the project allows extrapolating a number of key

elements for enhancing risk and performance alignment. An examination of these elements might help understand how close an organisation is, or can be, to link risk and performance management. This can be achieved by considering different issues: the presence of a clearly identifiable company-wide strategy that can be used as a reference frame for both risk and performance management activities, the use of risk registers to organise management activities, the presence of someone that helps senior managers to articulate and understand key risks, the use of KPIs and variance analysis to investigate unexpected trends both above and below expectations.

These issues consider different organisational elements and activities and may play a different role in the overall management of an organisation, certainly having a strategy is more critical than the type of use of variance analysis. Indeed, they are not presented as a structured set of elements that have to be met in order to obtain an optimal way of managing risk and performance management. On the contrary, they may simply be considered of interest to anyone who is willing to reflect on how close (or distant) an organisation is to align risk and performance management, considering they already emerged as important to reach alignment in a particular organisation. The apparent simplicity of some (e.g. the investigation of results exceeding expectations) can be considered as strength rather than a weakness, as it implies that it might be easier to implement changes in the current way of acting and thinking of an organisation.

In conclusion, integrating risk and performance management is not a matter of implementing a single management tool. It can be more important to focus attention to a set of organisational elements: some can constitute obstacles (barriers), some can facilitate incorporating risk into management processes (facilitators, levers). In the end, risk is often implicitly related performance management: performance management tools, if used in particular ways, can provide risk information with minor efforts.

The author is interested to hear from practitioners who would like to discuss any of the issues raised in this report and perhaps also share their experiences of risk and performance management practice. To contact the author, please email t.palermo@lse.ac.uk

Appendix

Interviews protocol

Performance management

- Performance management team: role and activities
- Performance management frameworks and information reported
- Use of performance information
- Frequency and direction of the reporting of performance information

Risk management

- Governance structure and key risks
- Risk team: role and activities
- Risk management process (actors, techniques and measures)
- Use of risk information
- Frequency and direction of the reporting of risk information

Internal audit

- Governance structure and key risks
- Audit team: role and activities
- Use of audit reports
- Frequency and direction of the reporting of internal audits

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