ENTERPRISE GOVERNANCE

By: Wim Van der Stede

Wim Van der Stede, CIMA professor at the LSE, explains why businesses should be more circumspect during a boom – and prepared to take risks when conditions get tougher.

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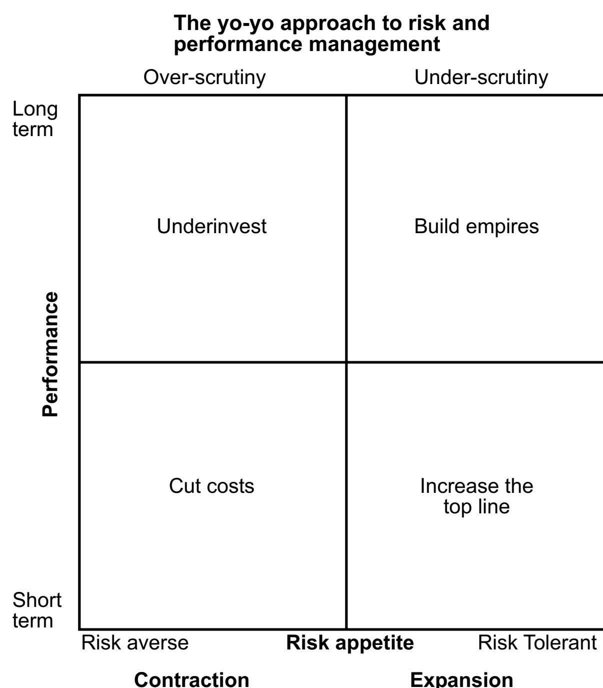
Companies tend to become complacent when business is good, letting their guard down when performance is meeting or beating expectations. But, when things are not going so well and targets aren't being met, they tend to overreact by tightening their belts too much. This is perhaps quite a natural reaction, yet it's also an outcome of the management-by-exception approach that most organisations use. This focuses on problem areas, assuming that all is well where targets are being hit. Some risk management practices also tend to do this, particularly quantitative tools (e.g., value at risk) based on historical figures that tend to look best when they should be looking worst – i.e., at the end of a boom.

As a business's performance goes through cycles, the level of management scrutiny tends to move inversely and asymmetrically to it. In other words, there is more vigour to combat contractions than there is sensible restraint or healthy scepticism towards unusually strong performance during expansions. While there may be plausible reasons for this, I am not convinced that it's good practice. Examples of lopsided performance scrutiny cycles are easy to find, particularly in the current downturn. Since the credit crunch began in August 2007, everyone has started to listen to risk managers again. Articles on risk management abound in the business press. In the immediate aftermath of a crisis we hear calls for government action. This was certainly true in 2002 following the collapses of Enron and WorldCom. These scandals spawned a slew of new policies and regulations on corporate governance and risk management worldwide. But, once a crisis passes, the new rules bed down, the boom times return and the cautious tone changes. Shareholders start to enjoy high returns once again and the appetite for scrutiny of any kind quickly wanes or, worse, is dismissed as a drag on performance. Similarly, the tendency inside many firms to investigate an unusual profit is weaker than the tendency to investigate an abnormal loss. Yet there's evidence to suggest that unusually big profits are often where the seeds of future distress are sown. They may be a sign that managers have been taking too many risks or been excessively short-termist, particularly where scrutiny has been lax. The crisis in the financial services sector is a case in point. Whatever the industry's ills are blamed on, they are to some extent self-inflicted: too much complacency when things were great, leading to a failure to ask tough questions and challenge assumptions.

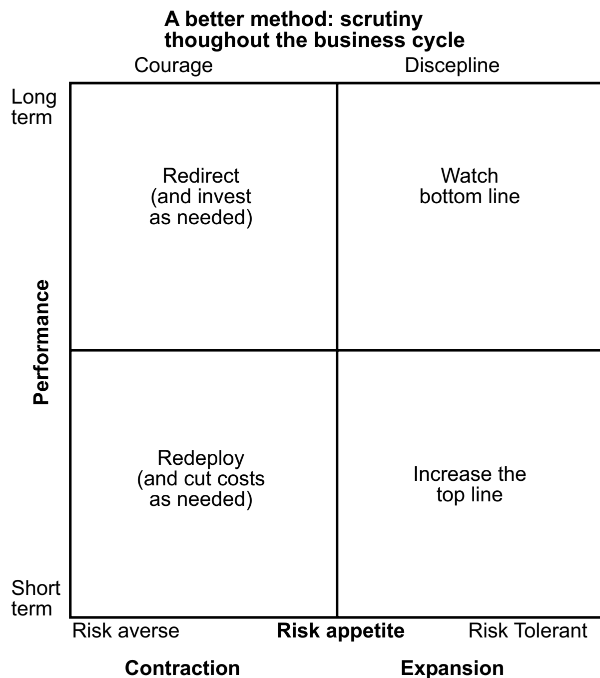
Under-scrutiny often prevails during periods when there is a focus on the top line, driven by aggressive, rose-tinted growth plans, overconfidence and weak controls. It often results in empire-building through risky investments and ill-advised acquisitions. Over-scrutiny, on the other hand, is characterised by a tightening of the screws through cost-cutting, a clampdown on investments (even worthwhile ones), balance sheet "clean-ups" and divestments (sometimes at huge discounts) driven by excessive risk aversion, over-compliance in the face of potential litigation and other stifling, protective attitudes. Clearly, neither situation seems ideal.



On the right half of the matrix in figure 1, companies are upbeat and overconfident when times are good and capital is readily available. Their tolerance for risk is high and they tend to emphasise growth through acquisition. This expansion may benefit the bottom line in the short term as new sales come in and some cost savings have an immediate effect, while other costs are amortised or "taken out" as one-off items. But such empire-building often earns substandard returns in the long term – hence the use of the colour red for danger in the top quadrants of the matrix. Examples abound of aggressive acquisitions, built on hubristically estimated synergies, that fail to create the value that was promised. The time factor is clearly important here, so it is depicted along the vertical dimension of the matrix. The short-term effects of weak scrutiny and excessive risk-taking on performance are often good, which further discourages firms to question such an approach.

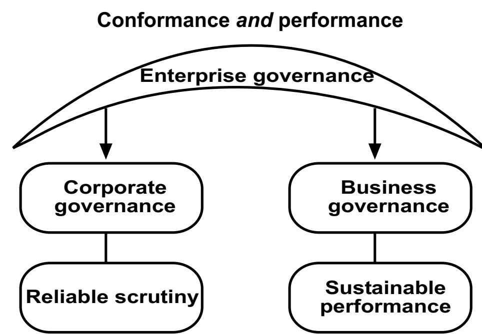
On the left half of the matrix, when the going gets tough and performance is weaker than expected, companies often lose their appetite for risk. In order to tackle their performance problems they often go for the low-hanging fruit: they cut costs, reduce R&D and raise the hurdle rate for accepting capital projects, thereby often underinvesting in otherwise promising enterprises. Again, the results of such actions are often beneficial in the short term, but they tend to hamper value creation, effectiveness and competitiveness in the long term. Again, what might seem to be wise decisions may well come back to haunt the company. Risk aversion in this case, rather than hubris, can put the business in jeopardy.

So how can companies have the discipline in good times to not overreach themselves and the courage in bad times to continue investing for the long term? How can the process of scrutiny be calibrated through the business cycle so that it makes managers appropriately risk conscious? The matrix in figure 2 illustrates the recommended approach. Note that the colour in the top quadrants is still amber, denoting caution. This makes the point that companies should not seek to eliminate risk entirely. Measured risk-taking is crucial in driving long-term performance, which inevitably involves uncertainty. Risk is, after all, what drives a wedge between a good decision and a good outcome, where it must be accepted that even good decisions made under appropriate scrutiny and with sensible restraint will not always have good outcomes. My key inference, therefore, is that if we are willing to accept that calibrating scrutiny and performance throughout the business cycle is desirable, then performance and risk management really are two sides of the same coin. They should be considered in unison rather than subjugating the level of scrutiny as a mere reaction to performance fluctuations.



Enterprise governance1 is a conceptual framework – not a practical tool per se – that puts reliable scrutiny and sustainable performance under one umbrella, addressing how firms might think about the need to align both items in the short and long term (see figure 3). It resonates with formal risk management approaches such as the enterprise risk management framework (ERM) developed by the Committee of Sponsoring Organisations of the Treadway Commission.

The ERM's formal definition posits risk management as a tool to provide "reasonable assurance regarding the achievement of entity objectives," which clearly marries risk ("assurance") and performance ("objectives"). By doing so with reference to risk appetite and emphasising "reasonable assurance," it also suggests that risk is to be managed, not eliminated. As such, risk management is



not only about ensuring that bad things don't happen, but also about ensuring that good things do happen. The ERM's definition also mentions the "board of directors, management and other personnel," indicating that risk management should pervade the organisation rather than remain the concern of a few senior people. So, even though performance and conformance may be separable, they are not independent. It is hard to consider one without the other, especially if you're taking a long-term view. But research suggests that organisations still often treat performance and risk management separately. For example, one study found that companies implemented ERM as a reaction to regulatory pressure and corporate governance requirements.3 They tended to do it not because it made good business sense, but rather because they felt obliged to. Yet, when asked about the benefits of adopting this approach to risk management, those same companies hinted primarily at performance benefits such as the ability to make better-informed decisions. Not surprisingly, they also mentioned some compliance benefits such as improvements to their corporate governance practices. They even mentioned some "cycle-busting" benefits – notably: reduced earnings volatility and improved performance.

So, although many firms have engaged reluctantly in risk management chiefly for compliance purposes, research suggests that the benefits of doing so have been mainly performance related. It also indicates that performance and risk management need not work against each other. I didn't set out in this article to assign blame for the financial crisis or to provide a "how to" tool for handling downturns – there are no easy answers for such complex issues. But I do hope that I've highlighted some spasmodic tendencies that cause performance and risk management to become misaligned and may contribute, at least partly, to adverse performance over time. With this in mind, firms can consider ways to rebalance their lopsided performance scrutiny cycles. Daring to ask the tough questions – even when nobody else does because they are too consumed by their current successes – is a good start. In respect of the current crisis, it would have been good to ask such questions about whether "millennium finance" really was the panacea it was thought to be.

Those banks that decided not to invest in complex financial instruments whose risks were misunderstood were "often pilloried for being boring," said Mervyn King, governor of the Bank of England, in April 2008, criticising the City of London's complacent attitude to risk. "Boring" should perhaps be understood as "appropriately prudent." Healthy scrutiny should be encouraged throughout our organisations. Risk management is not only about

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