Enterprise risk management and budgetary control: a management challenge

Research executive summary series

Volume 7 | Issue 6
Key findings:

- Enterprise risk management (ERM) implementation and its identification as a compliance and corporate governance device, is often adopted for external purposes. This poses potential risks to the managerial significance of ERM.

- ERM champions are central in shaping the managerial usefulness of ERM. There is a benefit in establishing alliances with other corporate functions, while always trying to find – and highlight – gaps in current systems of control.

- There is diversity of practice in terms of integration with budgeting ranging from full integration to complete separation. What is key in the diversity is the awareness of choice. In four cases, the diversity results from a deliberate process of defining a general framework of control, where ERM and budgets may or may not be integrated. However in two cases the wider framework of managerial control was neglected without considering existing processes. This led to ERM becoming a tool which was distant from managers and their actions.
Acknowledgements

The researchers would like to thank CIMA’s General Charitable Trust for funding this project and its support during the research. We also thank the Institute of Risk Management for its valuable help in the search of the UK case studies.

Introduction

Enterprise Risk Management (ERM) is increasingly claimed as a tool for improving the capability of companies in predicting and managing risks, enhancing planning and the achievement of their goals. This research argues that the managerial role of ERM and its link with budgeting is both a strategic and a management challenge for companies.

ERM may be considered the culmination of the risk management explosion (Power, 2007) which started during the 1990s. ERM is intended to be a holistic approach for assessing and evaluating the risks that an organisation faces (COSO, 2004). Interest in ERM has grown rapidly in the past 15 years and after recent financial scandals, there has been further pressure from various parties to adopt and embed ERM in business processes. In the UK, the publication and review of the Turnbull Report signalled a close coupling between internal control and risk management, making ERM a central focus of corporate governance.

Parallel to this centrality in corporate governance, ERM seeks to link risk management with business strategy and objective setting, entering the domains of management control, accountability and planning. Indications that ERM may have an impact on managerial processes and more specifically, on budgeting can be found in the ERM standard guidance (COSO, 2004), in academic papers and in the claims of practitioners and professional bodies.

Starting from this potential link between ERM and management control, a comparative international study was carried out to explore the possible role of ERM in managerial control, by studying its impact on budgeting. A multiple case study approach was adopted, investigating six companies that implemented ERM: three Italian companies and three UK companies. The data was collected between 2002 and 2010.

Objectives

The specific objectives of the research are:

- Analysing how ERM is technically implemented (i.e. measurement systems and types of interaction with managers).
- Analysing the heterogeneity of choices in terms of ERM responsibilities.
- Highlighting ERM impact on budgetary control.

Research methodology

The research was carried out using a case study approach. This approach was chosen to gain a deeper understanding of the actual impact of ERM on budgeting, but also to capture the nature of ERM within each of the organisations and the factors shaping its achievements. Information was gathered from a wide variety of sources: companies’ published reports; internal documents; archival data; newspapers for statements by top management; and other public coverage of the companies. However the most important source of data was face to face interviews. Six companies were analysed – three in Italy and three in the UK. To respect the non disclosure by the informants’ interviewees, we did not register the interview with the risk manager in UK-systems.

<table>
<thead>
<tr>
<th>Employees</th>
<th>Industry</th>
<th>Nationality</th>
<th>Interviews*</th>
</tr>
</thead>
<tbody>
<tr>
<td>ITA-tel</td>
<td>Less than 5,000</td>
<td>Telecommunications</td>
<td>Italian</td>
</tr>
<tr>
<td>ITA-info</td>
<td>Nearly 10,000</td>
<td>Automation, information and control</td>
<td>Italian</td>
</tr>
<tr>
<td>ITA-utility</td>
<td>Less than 5,000</td>
<td>Utility</td>
<td>Italian</td>
</tr>
<tr>
<td>UK-tel</td>
<td>More than 10,000</td>
<td>Telecommunications</td>
<td>UK</td>
</tr>
<tr>
<td>UK-utility</td>
<td>Between 5,000 and 10,000</td>
<td>Utility</td>
<td>UK</td>
</tr>
<tr>
<td>UK-systems</td>
<td>Less than 5,000</td>
<td>Systems, electronics and control</td>
<td>UK</td>
</tr>
</tbody>
</table>

*Overall for the Italian case, 42 interviews were carried out. These numbers refers to the interviews carried out under the CIMA grant.
Findings
The main findings of the researchers are related to three areas:
1. the variation in ERM techniques
2. the heterogeneity of ERM champions
3. the different impacts on budgetary control.

1. Variations in ERM techniques
The six cases showed evidence of variations in how ERM is technically implemented. Different approaches have been chosen which can be differentiated at the technical level upon three elements: how risks are measured; how they are presented in a unique framework/measure; and which type of interaction is maintained with managers (see table 2).

Four companies (ITA-tel, ITA-utility, UK-tel, UK-system) measure risks in terms of impact and probability with a qualitative scale, which are then presented holistically with a qualitative risk map. Despite the same measurement, there are differences in the managerial effectiveness of ERM which are linked to the type of interaction. More specifically, the two UK companies favoured a face to face interaction with managers, rather than a questionnaire approach. The higher interaction transformed the risk data collection by way of discussion and reflection with managers, also highlighting overlapping with pre-existing risk management analysis.

The two UK companies involved different figures during the discussion, marking a different focus for ERM. UK-tel focussed the discussion and interaction at the strategic level, while UK-system spread the ERM culture and awareness through its project managers, who are key in the running of the business.

Table 2 – the ERM technique

<table>
<thead>
<tr>
<th></th>
<th>Risk measurement</th>
<th>Synthesis/framework</th>
<th>Type of interaction with managers</th>
</tr>
</thead>
<tbody>
<tr>
<td>ITA-tel</td>
<td>Qualitative scale</td>
<td>Risk map</td>
<td>Through questionnaires – once a year</td>
</tr>
<tr>
<td>ITA-info</td>
<td>Impact on profit</td>
<td>Risk map and profit at risk</td>
<td>Through meetings – continuous</td>
</tr>
<tr>
<td>ITA-utility</td>
<td>Qualitative scale</td>
<td>Risk map</td>
<td>Through questionnaires – once a year</td>
</tr>
<tr>
<td>UK-tel</td>
<td>Qualitative scale</td>
<td>Risk map</td>
<td>Through meetings – monthly</td>
</tr>
<tr>
<td>UK-utility</td>
<td>Impact on profit and cash</td>
<td>Risk capital</td>
<td>Through meetings – continuous</td>
</tr>
<tr>
<td>UK-system</td>
<td>Qualitative scale (with indication of financial ranges)</td>
<td>Risk map</td>
<td>Through meetings – continuous</td>
</tr>
</tbody>
</table>

The importance of interaction is even more visible in the two most managerially embedded ERMs: ITA-info and UK-utility. Here the level of interaction may be addressed as pervasive and continuous. The pervasive interaction is achieved by devoting considerable human resource to ERM. In both companies the chief risk officers (CRO) have teams of 12 to 15 people who support managers across the organisation.

In a ‘virtuous cycle’, the managerial significance of ERM is further increased in ITA-info and UK-utility by adopting quantitative measures, which allow managers to better view ERM risks as real and relevant to their actions. The Italian company measures the impact in terms of profit, while the UK company assesses impact both on cash and profit. The quantification and discussion of all these risks then lead to two aggregated measures: profit at risk (ITA-info) and risk capital (UK-utility). This latter concept is an attempt to quantify that portion of the company’s resources which is deemed to be ‘at risk’ during normal business operations. The proportion of risk capital is a major consideration in new investment programmes.

2. Heterogeneity of ERM champions
One of the first challenges companies need to face when they undertake ERM is choosing who is going to implement the system and who will manage it on a routine basis. The six companies analysed all chose to develop ERM without employing external consultants. However, they can be differentiated on three main interrelated decisions: which competencies and backgrounds they wanted; whether or not they hire a new person; and where the implementers were positioned within the organisation.
Table 3 – the ERM champions/owners

<table>
<thead>
<tr>
<th></th>
<th>Background and competencies</th>
<th>Newly hired</th>
<th>Organisational hierarchical positioning</th>
</tr>
</thead>
<tbody>
<tr>
<td>ITA-tel</td>
<td>External auditing consultancy</td>
<td>Externally hired</td>
<td>Internal auditing</td>
</tr>
<tr>
<td>ITA-info</td>
<td>Management accounting</td>
<td>Designated from inside</td>
<td>Management accounting</td>
</tr>
<tr>
<td>ITA-utility</td>
<td>Internal auditing</td>
<td>Task assigned to internal audit, no dedicated figures</td>
<td>Internal auditing</td>
</tr>
<tr>
<td>UK-tel</td>
<td>Risk management consultancy</td>
<td>Externally hired</td>
<td>CFO and audit committee</td>
</tr>
<tr>
<td>UK-utility</td>
<td>Operational risk management</td>
<td>Designated from inside</td>
<td>Executive committee and group risk director</td>
</tr>
<tr>
<td>UK-system</td>
<td>Project management, Internal auditing</td>
<td>Designated from inside</td>
<td>Internal auditing</td>
</tr>
</tbody>
</table>

Two companies decided to search for competencies outside the organisation (ITA-tel and UK-tel). In both cases the experience in consultancy was favoured although the Italian company hired a former external auditor, while the UK company enrolled a consultant with specific experience in risk management. The other four companies opted to search for internal corporate competencies and in one case (ITA-utility), without assigning ERM to a dedicated person. Here the ERM process is directly carried out by the internal auditor. Two companies assigned the task to a person with considerable experience in operational risk management (UK-utility) and in management control (ITA-info). Finally, UK-systems assigned responsibility for ERM implementation to a senior manager within the internal audit function, who has a varied and long experience within the company — including work as a project manager. The hierarchical relation of the ERM champions is varied: positioned within internal auditing; under management control, under the chief financial officer or the executive committee. In this respect it is important to highlight that in UK-system, the ERM project manager is part of internal audit, but has a close relationship and a strong commitment from a key operational director.

The two most effective ERMs have set a link with the managerial actions and processes of the company. In ITA-info and UK-utility the CRO were hierarchically positioned under functions which provide information and internal advice to managers and not only external assurance.

Furthermore, in both cases the CROs did not work alone but made alliances with other related corporate roles — risk specialists and management accountants — trying to improve the overall framework for management control. This is done by:

- Discussing the information to be collected to avoid overlapping but also to challenge different perspective in predicting future opportunities and risks.
- Analysing the information collected and highlighting possible areas overlooked by managers.
- Revising ERM, risk specialist practices and the management accounting cycle coherently and jointly.

3. Different impacts on budgetary control

The six cases highlighted that the managerial role of ERM and its impact on budgeting is a challenge. This is primarily linked to the need to find a space within existing management control systems. In all six organisations analysed, there were other processes dealing with risk before the introduction of ERM. Specifically, two types of expertise were present: the risk specialists in charge of specific categories of risks, such as financial risks and Information Technology risks; and management accounting, where risks are considered within the planning and control cycle.

The following table presents the relationship between ERM and these processes in the six companies.
Table 4 – the ERM relationship with risk and control processes.

<table>
<thead>
<tr>
<th>Relationship with risk specialists</th>
<th>Management accounting</th>
</tr>
</thead>
<tbody>
<tr>
<td>ITA-tel</td>
<td>Separated</td>
</tr>
<tr>
<td>ITA-info</td>
<td>Supporting managers, CRO and the controller within ERM framework</td>
</tr>
<tr>
<td>ITA-utility</td>
<td>Separated</td>
</tr>
<tr>
<td>UK-tel</td>
<td>Supporting both CRO and managers</td>
</tr>
<tr>
<td>UK-utility</td>
<td>Supporting managers, CRO and the controller within ERM framework</td>
</tr>
<tr>
<td>UK-system</td>
<td>Supporting both CRO and managers</td>
</tr>
</tbody>
</table>

In two cases, ITA-tel and ITA-utility, the risk specialists and management accountants continue to carry out their processes separately without using the information collected and processed by ERM. In one case, UK-tel, management accounting dealt separately with short and medium term risks and the CRO dealt with strategic risk with the advice of risk specialists.

An intermediate situation is represented by UK-system. At present, the company is still developing ERM and all the corporate roles—and even project managers—are collaborating to find the best way to integrate three type of analysis: budgeting, project risks and ERM. Two cases show a higher level of embedding of ERM: UK-UTILITY and in ITA-INFO. Here CROs, risk specialists and management accountants collaborate in the attempt to build an overall risk and control awareness in managers.

In the case of ITA-info the link between ERM and management accounting is highest, and a new form of ERM-budgeting has emerged. All ERM information is made available to the controller and used in every phase of the budgeting process. The controller and the CRO review the most up-to-date risk map, which is used to gain an understanding of the main risks faced by the company and to fill possible gaps. During the negotiation, the business units are asked to include in the budgeting all those events having a probability greater than X%, and a financial impact exceeding a threshold Y. The overall risk map and the information provided by managers sometimes reveal that certain risks have been neglected. When such risks might have a significant impact, a corporate reserve is created to counterbalance possible negative events neglected by division managers. Management reserve is subsequently freed up and the corresponding amount allocated to the business unit responsible for the variance. This emphasis on risks also has a more subtle influence on managers’ mindsets. When a number is entered into the budget they carefully evaluate all the risks related to it, but they also revise the risk map accordingly.
Conclusions

This study has evidenced three main challenges, each with practical implications.

The first challenge is related to the positioning of ERM as a managerial tool. ERM is often linked to corporate governance needs and external requirements, which may undermine its implementation as a tool for enhancing managerial actions and decisions. The cases highlighted that the choices in terms of measurement – qualitative versus quantitative – owners or champions approach – interactive versus diagnostic – and hierarchical line or commitment – management control, internal auditing, strategic committees – do affect the perception of its managerial usefulness within the organisation. This perception of usefulness is essential for an effective implementation not only for convincing managers in using ERM, but in turn also for the essential need to have management collaboration for the implementation and continuous evolution of ERM. In the cases in which ERM has become a managerial instrument, there is a collaborative tension between ERM owners and managers, who are continuously challenged to think of the unexpected – the so-called ‘Black Swan’ effect (Taleb, 2007).

The second challenge is related to the space for the ERM champions or owners within the corporate roles already in charge of controlling risks at the managerial level. These roles include management accountants but also risk specialists. When other systems of risk management and control are perceived to be satisfactory by managers, ERM – and its owners – struggle to find a space. Our research revealed a new managerial sensitivity is achieved by showing them real examples of how current systems may fail to holistically manage risks or to manage those with a longer term perspective. This does not mean a contraposition with other corporate roles. On the contrary, the more effective cases evidenced a constant search from the ERM owner of alliances with other actors in charge of controlling risks and company performance.

The third is both a challenge and a strategic choice: the integration of ERM and budgetary control. The six cases showed a spectrum of situations moving from:

- Process and output integration – ITA-info
- Output integration such as risks and performances – UK-utility
- Reciprocal consideration – UK-system, though this case is still evolving
- Voluntary separation posing ERM as a strategic tool and budget and its risks as a short/medium term device – UK-tel;
- Unaware separation – ITA-tel and ITA-utility.

After the internal presentation of our analysis in ITA-tel, the controller is now undertaking work to integrate risk outputs in its balanced scorecard.

Further reading


Authors

Michela Arnaboldi
Dipartimento di Ingegneria Gestionale – Politecnico di Milano
Piazza Leonardo Da Vinci, 32
20133 Milano – Italy
T: +39-02-23997328
E: michela.arnaboldi@polimi.it

Irvine Lapsley
Institute of Public Sector Accounting Research –University of Edinburgh Business School
29 Buccleuch Place
Edinburgh EH8 9J5
T: +441316503790
E: Irvine.Lapsley@ed.ac.uk