

MANAGING STRATEGIC RISKS FROM MANAGEMENT CONTROL APPROACH

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Abstract

It is this conceptual paper's intention to show the use of a management control approach to managing strategic risks. This theoretical work presents and conceptualizes strategic risk, categorizes strategic risks (examples taken from financial industry are used) and presents a management control framework to manage with these risks strategically. The paper illustrates the need to identify strategic risks proactively and to integrate risk management tools into overall company strategic management. It suggests that risk management is critical for an organization's survival; it needs to have a company-wide strategic approach and backed by the top management of the organization. The paper also suggests that shareholders are ultimately responsible for the way the risks their companies face are managed. The recent financial crisis has generated a considerable amount of discussion around what regulators can do or could have done, while forgetting proper controls system by owners (shareholders) to influence and control the behavior of the managers of their own companies.

Keywords: Risk Management, Management Control, Strategic Management, Financial Crisis.

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Introduction

The idea that company risk is or should be far from a random risk is not new. What's more, the expression "to place a company at risk" identifies behaviours that are no doubt very distant from the intentions of any company owner. Any shareholder is intuitively aware of taking risks in their company but the concept of risk management as such is much more recent. The latest financial crisis or historical cases such as the corporate disasters of Merrill Lynch, Société Générale, Barings Bank, Sumitomo, Prudential, Metallgesellschaft and Diawa should be a lesson to company managers indicating which risk situations are unacceptable to shareholders (Mishkin, 2001).

This article is not in line with the debate on financial sector regulation. It is not about company owners willing to do "bad things" for which laws exist, it is about "the company" or its managers running it against the long term interests of shareholders and other stakeholders. Managers in pursuit of corporate objectives or their bonus, especially if they are ill defined or short term oriented, might take decisions against the long term interests of shareholders.

Normally, company managers are aware of the importance of this type of management, although risk management generally tends to be viewed within the framework of abiding by the rules, and this management is carried out separately in each functional area without any coordination between areas (financial, technological, environmental, etc.). This idea of risk management is a long way from comprising a strategic tool for improving an organisation's performance. Risk creates opportunities.

Opportunities create value and value ultimately creates value for shareholders (Stephenson and Bendall, 2001). Therefore, identifying, measuring and effectively managing the risks an organisation is subjected to opens up real opportunities for creating added value.

Risk Categories

Risk may be defined as any event that adversely affects an organisation's capacity to successfully achieve its objectives and implement its strategies. These risks may be both internal and external. Although the recent financial crisis has blatantly put on the table the significance of risk management in financial institutions, the conceptualization and use of the tools described in this article applies to all kinds of companies. We will classify the risks that companies are exposed to into four categories: operational risks, depletion of assets and competitive risks (Simons, 1998), as well as the risk of legal non-compliance.

Operational risks are those that typically affect companies which create value via the production of goods or services. These risks involve the possible interruption of the company's capacity to provide these products or services (i.e. the delivery of faulty products to customers, lack of capacity to meet customer orders or mistakes in registering customer transactions).

An operational risk becomes a strategic one when the fault is critical. For example, in the bank industry the lack of credit availability prevented banks from being able to perform basic operations such as lending to their customers or refunding customer deposits. The consequences are devastating. The company's strategic

position will determine the definition of its strategic operational risk. The more the company decides to compete by excelling in product quality the higher the degree of operational risk it is taking.

As far as the second category is concerned, an asset is a resource that an organisation possesses in order to create cash flow in the future. **Depletion of assets** involves a significant loss in the value of this asset, of its capacity or likelihood of generating these cash flows. These risks become strategic risks when this loss of value affects the organisation's capacity to implement its strategy.

Asset depletion may be financial or physical and it may affect both tangible and intangible assets:

- Financial depletion results from a significant drop in the market value of assets. The case of mortgage backed securities falls clearly into this category, the write-down of these assets has led to a deterioration in the balance sheet of all banks involved, downgrading their credit ratings and the subsequent withdrawal of credit to end users that has already been identified as operational risk before. Insolvency of customers who borrowed money should also be included in this section.

- The capacity of many companies to generate value currently depends on their intangible assets (e.g. a credit card portfolio, the listing of customers relationships or the bank core depositors) which do not appear on the balance sheet. The possibility of a deterioration in these intangible assets represents a significant strategic risk (Reilly and Schweih, 1998).

- A third possibility is the physical deterioration of material assets which refers to the destruction of installations, machinery or inventories.

The third risk category is **competitive risk** which by definition affects all businesses which are not monopolies. In order to identify the origin of these risks we can make use of the five forces analysis model (Porter, 1980): competitors, customers, suppliers, new competitors and new products. However, in addition to the external risks intrinsic to the rules of competition, competitive risks may also arise from the actions of employees and this is the situation we are interested in from the viewpoint of a management control system since the actions of employees could lead to the loss of customers or suppliers, the purchasing of substitute products by customers or the entry of new competitors.

Finally, there is the **risk of legal non-compliance** with laws, regulations and directives, which the company activity must abide by, as well as the obligations ensuing from agreements entered upon with other parties that may involve obligations or sanctions (Osterfelt, 2005). This must be understood as the consequence of behaviours not intended by the organization which is different from intentionally fraudulent actions such as Madoff's Ponzi scheme or Stanford International Bank in which, despite assurances that the money was going into liquid securities, much of it was apparently ploughed into property and private equity.

The extreme outcome of the abovementioned risks is the company's **risk of losing its reputation**. This loss of reputation occurs when the value of the entire business

deteriorates due to the loss of trust on the part of the main stakeholders (customers, suppliers, partners, etc.) or when the problem jeopardises the viability of the enterprise. We clearly witnessed a large decrease in the market value of banks and a reassessment on behalf of customers as to the reliability of the institutions themselves. Since the value of a business depends on the willingness of customers to pay for a series of attributes, a substantial interruption in operations, a drop in the value of assets or the erosion of a company's competitive advantage will negatively affect the perception that customers have of the company (Simons, 1998). A bank's reputation could be its most valuable asset. As we saw in the mid-1980s with Continental Illinois, a significant blow to a bank's reputation can precipitate a liquidity crisis and result in the failure of that bank (Barrickman, 2002).

Risk Management

Managing reputation risk, not only must be a corporate wide effort, it must be directed by top management. Risk management begins by identifying the state of affairs. As Epstein & Buhovac (2006) point out, organisations must start off by making a comprehensive list of potential risks at an organisational level. It should be pointed out that the simple fact of listing an organisation's potential risks will undoubtedly draw the attention of managers and employees to these possible developments. Each company can develop a combination of techniques and instruments in order to identify these risks. By developing these tools we increase our chances of determining their origin and identifying relevant risks for the organisation.

Once these risks have been identified we need to gauge their impact and importance. Measuring the impact of risks entails weighing up their magnitude, the likelihood of their occurring, quantifying their impact and prioritising risks by means of a cost profit analysis.

The company's potential responses (Epstein and Buhovac, 2006) need to address the following question: *"Is the risk-profitability profile acceptable?"*, the answer will lead us to one of the following options:

- Accept. Do not take any actions to alter the likelihood of the risk or its impact. Typically, organisations accept risks because they can put up with the impact (or transfer it or reduce it to tolerable levels). It is top management's responsibility to discuss and clarify the risk categories with the management board and determine the degree of exposure that they consider acceptable for the enterprise.

- Share. Reduce the probability of risk or its impact by sharing a portion of the risk.

- Transfer. Pass on the risk to an independent third party that is financially able to take on a reasonable economic cost under a legally binding agreement. For many years, subscribing an insurance policy was seen as the only risk management tool that companies had access to.

- Reduce / Mitigate. Carry out actions to reduce the likelihood or the impact of the risk or both. Setting up controls to address risks is a form of mitigation. It is the

responsibility of management to assess the company's capacity to reduce the incidence of risks and their impact on the business and to implement essential control tools.

– Avoid. Stay away from activities that expose the company to unacceptable risks.

Those risks that the company decides to accept, share, transfer or mitigate need to be monitored by the control system. The term “Management Control Systems” could have numerous meanings depending on the context in which it is applied or discussed (Herath, 2007). There is a general consensus that “[Management] control is used to create conditions that motivate the organization to achieve desirable or predetermined outcomes” (Fisher, 1998). We shall define management control as any actions or activities taken to influence the likelihood of people behaving in ways that lead to the attainment of organisational objectives (Flamholtz, 1983).

A way to do so would be to make use of the management control system framework of the four levers of control (Simons, 1994, Simons, 1995): boundary systems, belief systems, diagnostic control systems and interactive control systems. The suggested strategic risk management tool involves setting effective boundaries, both as regards conduct and strategic limits along with the introduction of internal control systems.

In dynamic organisations, employees need to be able to make decisions and take on responsibilities. In order to ensure that an organisation's employees devote themselves to the right activities we need to transmit a series of values which outline basic principles, intention and direction. The **belief system** is the set of values that top management communicates formally and systematically reinforces in order to provide the organisation with core values, intentions and direction, including how value is created and the expected level of performance. The starting point is a values statement which will concisely communicate how the company and each employee are to approach customers, colleagues, risk philosophy and risk evaluation. Copies should be distributed to each employee (Barrickman, 2002).

Once we have given decision rights, and a set of values and beliefs as a framework for decision making, we also need to establish a boundaries system to set limits to what one can and cannot do. Like any other management control system, it needs to establish a system of rewards and sanctions aligned with these boundaries. However, in the case of boundaries, it doesn't make much sense to reward people for not overstepping them whereas it seems more logical to impose sanctions for transgressing the boundaries.

Limits of conduct system set acceptable standards of behaviour for employees. It normally lists everything that is prohibited, linking it to specific sanctions and the possible threat of sanctions. Boundary systems are designed to specify the risks that should be avoided and to do away with the rationalisation of actions that could expose the organisation to unacceptable risk levels (Simons et al., 2000).

But belief and boundary systems are not enough to avoid ill-intentioned behaviours and mistakes. We also need to put in place internal control systems. **Internal control systems** are comprised of policies and procedures

designed to protect a company's assets and guarantee reliable information and accounting systems, reducing the chances of unwanted behaviours either deliberate or accidental.

The internal control system will include the following factors:

- Competent personnel in accounting and control, a good accounting system.
- Written procedure manuals.
- Delimitation of responsibilities: No one controls an entire transaction.
- The physical protection of assets.
- Restrictions on employees who manage assets and information
- Authorisation in order to carry out transactions.
- Employees who manage assets should not also be responsible for recording movements into the books.
- Support documents for inspection.
- Checking of registers and assets.
- Internal / External Audit.

There is another type of risk that may jeopardise a company's long term profitability is the risk of using resources and initiatives which are not aligned with the business strategy. When the organisation incentivates the quest for new opportunities, top management needs to ensure that employees do not pursue opportunities that are outside of the intentions of upper management and that it has no interest in supporting. **Strategic boundary systems** consist of ensuring that the workers of an organisation dedicate their activities to supporting the business strategy and making it clear which business opportunities are not in the company's interest.

Choosing these is crucial to the strategy. We could say that the difficult part of defining the strategy is deciding what not to do. A company's strategic limits therefore form an integral part of the strategy definition process. These limits may involve the following considerations:

- Minimum profit levels.
- Maximum level of risk to be taken.
- Minimum levels for sustaining a competitive advantage.
- Products or services that do not fall within the key competencies of the organisation.
- Markets and competitors that need to be avoided.

In addition to belief and boundary systems, the other two levers of Simons' control model –diagnostic control and interactive control systems- may also be used as risk management tools.

Diagnostic control systems are formal information systems which are used by management to monitor the company's results (in general, not only financial) and to put right deviations from the set standards. The objective of these diagnostic systems is to reduce the time top management needs to devote to management operations. Upper management only needs to look into those indicators that deviate from the set standards, thus adopting a management by exception approach. Countless indicators may be used to manage each different type of risk. Here are some examples:

– Operational risks: liquidity and risk indicators, the amount of time assets stay in bank inventory, percentage of short-term funding of long-term assets.

– Risk of asset depletion: the inclusion of uninsured derivatives on the balance sheet or subprime financial products, unrealised profit and loss, credit concentration.

– Competitive risks: new products brought out by competitors, shifts in consumer habits, changes in distribution channels.

– Risk of legal non-compliance: Changes in legislation, pending legal proceedings, number of faults reported internally.

For all these indicators the company management can set fixed values. It can then devote its attention to the cases where these values are exceeded. As long as the values remain within acceptable limits they are not required to take action.

Finally, the fourth lever in the control model, **interactive control systems**, is defined as formal information systems that managers use to involve themselves personally in the decision making activities of their subordinates via debate and feedback. This involvement means, the CEO, executive management, and line managers should refer to and reinforce the values statement with each executive and bank lending decision.

The adjective *interactive* does not describe the tool as such but the use that is made of it. All management control tools can be used interactively in order to exchange relevant information. In contrast to diagnostic tools –which aim to save time for management as a valuable resource, and which require intervention only by exception- interactive systems require the direct involvement of management in meetings with subordinates and they are especially useful for identifying threats and opportunities for the company. The very fact that this formal dialogue or feedback exists reinforces its importance across the organisation.

Finally, it is essential that the incentives scheme be aligned and that it reinforce the bank's values. We can learn from this crisis the impact that incentives can have on individual ethics and behavior. An incentives scheme heavily weighted towards stock options and the promise of phenomenal wealth, generated by the rising value of these same options can easily prompt corporate CEOs and CFOs to make decisions that go against the bank's values or even to manipulate earnings to maintain or increase stock prices. Similar pressure can be exerted on lenders if an individual lender's compensation heavily depends on the number of loans they generate without equal incentives for asset quality and timely and accurate assignment of asset quality (risk) ratings. (Barrickman, 2002).

Conclusions

There is a substantial difference between plain financial and operational risks (the normal risks any business must assume in the course of its day to day operations) and an event which can adversely affect an organisation's capacity to successfully achieve its objectives and

implement its strategies. There is a strong need for businesses to undertake the process of identifying and consequently managing those risks that could jeopardise the organization's continuity and consequently shareholder value.

Risks can be categorized (operational risks, depletion of assets, competitive risks and legal compliance) to help their identification. There can't be receipts for the identification of strategic risks since they depend on a particular company operating in a certain market at a specific point in time, under specific circumstances and with a particular strategy. The company's strategy and identifying the Key Success Factors constitute the main tool for determining the assumptions the corporate strategy is built on and therefore what could ultimately jeopardise these assumptions.

Management control systems the purpose of which is to increase the likelihood of achieving the strategic goals of the company are, together with capable internal controls, an effective tool for dealing with these risks. In accordance with Simons's framework of levers of control, the Belief system (written values statement and its formal communication throughout all levels) and, the limits of conduct and strategic limits constitute the main tools for dealing with these risks. Another two levers, diagnostic (real risk indicators) and interactive (regular reinforcement of corporate values by testing every decision at all levels against the values statement as well as the regular and formal assessment of this communication) also play an important role, whereby the interactive use of control systems is also a key tool for identifying new risks.

Risk management must not be perceived as a departmental duty. Like the management control system itself, it must be managed company-wide and directed by the CEO. It is too important to delegate to another executive officer. Finally, due to the perverse impact that incentives schemes can have on managers behaviour, they must be assessed to ensure that they are aligned with the long term goals of shareholders and that they always reinforce the company's values.

While there has been a considerable amount of discussion on what regulators can do or could have done about the financial crisis, the fundamental role of management controls systems in explaining this crisis has received much less attention.

Although the risk taken on by some financial institutions was beyond the interests and the knowledge of their owners, there may not necessarily be a need for regulation but for a proper controls system by the owners (shareholders) to influence and control the behavior of the managers of their own companies.

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