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# Weaving Enterprise Risk Management into Strategy

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*In this article, Sean McGing considers how valuable it is for a Board to explicitly consider risk as an integrated aspect of an entity's strategy.*

## 1 Introduction

The Board's primary role is to set and oversee the implementation of the strategy to achieve their entity's mission and vision. Integral to strategy is the level of risk an organisation is prepared to take, and hence in this context the board sets risk policy and ensures the entity's risk management framework implements that policy. However, in the last ten years, the value of risk management has increased: whereas in the past, strategy and risk were treated separately, it has become apparent in recent times that the value of risk management is maximised if the two are explicitly linked.

## 2 Traditional approach to Board Governance on Risk Management

When Boards consider risk management, what first comes to mind? If you are a Director, your answer will depend mostly on the nature of your business, your industry, the size of your entity, and your experience. But the most natural response of the human mind is that the word 'risk' invokes thoughts of a threat or more likely multiple threats. Murphy's Law comes to mind -- "If anything can go wrong, it will", and those of us with an Irish heritage know that Murphy was not an idiot! The adrenalin kicks in and we are in fight or flight mode.

The good practice Board will, of course, already have established its fight defences. Listed Boards are required to adhere to the ASX Corporate Governance Council (ASXCGC) Principle 7: Recognise and manage risk.[1] It states "Companies should establish a sound system of risk oversight and management and internal control." The good practice non listed Board including that of a "not for profit" organisation will have embraced that principle and applied it to their organisation. Both will have implemented the ASXCGC recommendations, the key elements of which are:

- 7.1 -- establish policies for the oversight and management of material business risks.
- 7.2 -- require management to design and implement the risk management and internal control system.
- 7.3 -- that the system [of risk management and internal control] is operating effectively in all material respects in relation to financial reporting risks.

A mindset based on these principles and the "threat" of risk, can however encourage too much focus on compliance and defence at all levels of an organisation, to the detriment of viewing risk in the context of opportunities, balancing both risk and reward as part of the strategy.

## 3 A change of mind set

The best practice Board focuses on its core role and responsibility to attain the objectives of the organisation on behalf of its shareholders and members. Explicitly including consideration of risk as an integral part of pursuing those strategic objectives increases the likelihood of achieving them at least risk and greatest gain.

This requires a consequential change in mindset and behaviour of the Board Directors which needs to flow from the Board's leadership through the organisation. A shift in stance is required to get the Board back on the front foot. Instead of considering the threats, the Board should look for opportunities and be more proactive rather than just compliant. The best form of defence is attack.

To maximise the value of risk oversight and management, the language and behaviour around risk needs to become the language and behaviour of its strategy, including recognising the potential downsides and managing them appropriately.

## 4 Board enhancement of strategy through risk consideration

Back in 2003 John Uhrig,[2] in his review of corporate governance of statutory authorities, explicitly recognised this link between strategy and risk when he defined governance as "the arrangements that delegate and limit the control of strategy and direction to enhance long term success taking into account risks and environment." More recently Curley et al[3] argued that such governance is critical to the sustainability of organisations which is a core requirement of any Board strategy.

Norman Sheehan[4] found that Boards that integrate strategy formulation and risk management should achieve higher stakeholder returns and be more adaptive than rivals. The Australian Institute of Company Directors (AICD) in their education of directors[5] strongly endorses this view.

Bill Liabotis and Donald Baer in their article[6] on the strategic trade-offs between growth and risks conclude that: "Focusing on the market and profitability potential of each option is a good starting point, but in itself this can lead to disastrous results. Similarly, concentrating exclusively on risk can significantly limit the firm's growth potential." Notice again the negative / threat connotations around risk.

## 5 How to implement

Boards should lead from the top by example, thus setting the tone for a positive and active risk culture for the organisation. Risk and related opportunity (risk downside and risk upside) should be explicitly evaluated for each strategy being considered.

The Board should require the CEO to have management processes which ensure that the risks -- upside as well as downside -- are evaluated on the implementation of strategic business initiatives with the ability to change the implementation in light of the risk assessment findings en route.

The aim is that over time the organisation's culture comes to automatically consider the risk equation as naturally as the current economic profit/loss (cost/benefit) focus that drives most companies.

## 6 Conclusion & Recommendation

### *6.1 Conclusion*

Consider and assess the risks and opportunities (risk downside and upside) that might accompany each of the strategies a board considers. Integrate a continuing risk consideration in tandem with the implementation and ultimate monitoring of those strategies. This will give the organisation an improved awareness of value-adding opportunities while reducing the downside risk of reduced growth or loss of sustainable advantage.

### *6.2 Recommendation*

Boards should explicitly ensure that all strategic options are evaluated from a risk perspective simultaneously with economic and other perspectives. Risk should take into account the likelihood of both adverse and favourable scenarios as well as their consequences on a full range of risks that are material for the organisation such as profitability, solvency, sustainability, and reputation.

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1 ASX Corporate Governance Council, 2010, *Corporate Governance Principles and Recommendations with 2010 Amendments*.

2 Uhrig J, 2003, *Review of Corporate Governance of Statutory Authorities and Office Holders*.

3 Curley S, Cutter A, & McInerney A,  Institute of Actuaries of Australia, 2011, *Scheme Governance -- important for sustainability or flavour of the month?*

4 Sheehan, N., 2009, Journal of Business Strategy, *Making Risk Pay: The Board's Role*.

5 Australian Institute of Company Directors, 2012, *Company Directors Course*.

6 Liabotis B. &  Baer D., 2009, *Managing a portfolio of Growth Options: The Strategic Tradeoffs between Growth and Risk*.