

BY MARK S. BEASLEY, CPA, AND  
MARK L. FRIGO, CMA, CPA

Expectations that boards of directors and senior executives are effectively managing risks facing an enterprise are at an all-time high. Much of this shift in expectations is in response to recent corporate scandals and resulting changes in corporate governance requirements, such as the Sarbanes-Oxley Act of 2002 (SOX) and the NYSE Corporate Governance Rules updated in 2004. More recently, debt rating agencies such as Standard & Poor's, Moody's, and Fitch have announced their examination of enterprise-wide risk management practices of institutions as part of their overall credit-rating assessment processes.

# STRATEGIC RISK MANAGEMENT: CREATING AND PROTECTING VALUE

This shift toward greater expectations for effective enterprise-wide risk management oversight is complicated by the fact that the volume and complexities of risks affecting an enterprise are increasing as well. Ernst & Young's 2006 report, *Board Members on Risk* (see [www.ey.com](http://www.ey.com)), found that 73% of independent board members surveyed believe that the overall level of risks they face has risen over the last two years, with 41% indicating that the increase has been significant. Rapid changes in information technologies, the explosion of globalization and outsourcing, the sophistication of business transactions, and increased competition make it that much more difficult for boards and senior executives to effectively oversee the constantly evolving complex portfolio of risks.

The rise in volume and complexities of risks is complicated by the fact that many of the techniques used by boards and senior executives are dated, lack sophistication, and are often ad hoc. This further expands an "expectations gap" between what stakeholders expect boards and senior executives to do regarding enterprise-wide risk management and what they actually are doing.

In response to these changing trends, more organizations are embracing an emerging business practice known as enterprise risk management (ERM) that emphasizes a top-down, holistic approach to effective risk management for the entire enterprise. The goal of ERM is to increase the likelihood that an organization will achieve its objectives by managing risks to be within the stakeholders' appetite for risk. ERM done correctly should ultimately not only protect but also create stakeholder value.

ERM differs from a traditional risk management approach, frequently referred to as a "silo" or "stovepipe" approach, where risks are often managed in isolation. In those environments, risks are managed by business unit leaders with minimal oversight or communication of how particular risk management responses might affect other risk aspects of the enterprise, including strategic risks. Instead, ERM seeks to strategically consider the interactive effects of various risk events with the goal of balancing an enterprise's portfolio of risks to be within the stakeholders' appetite for risk. (See the sidebar, "ERM Defined.")

The Conference Board's 2007 research study, *Emerging Governance Practices in Enterprise Risk Management*, notes that while many organizations are engaging in some form of ERM, only a few have full-fledged ERM program infrastructures. Many of these organizations ini-

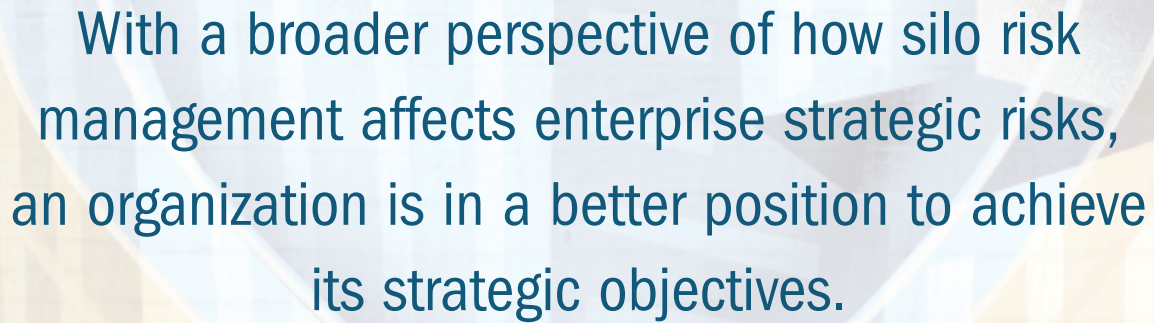


## ERM Defined

Several conceptual frameworks have been developed in recent years that provide an overview of the core principles for effective ERM processes. In 2004, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) issued its *Enterprise Risk Management—Integrated Framework* with this definition of ERM (see [www.coso.org](http://www.coso.org)):

*Enterprise risk management is a process, effected by the entity's board of directors, management, and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within the risk appetite, to provide reasonable assurance regarding the achievement of entity objectives.*

There are several key elements to this definition. First, ERM has to be driven from the top. The board of directors and senior executives set the tone and direction for enterprise-wide risk management. Second, ERM is directly related to strategy setting. For ERM to be value creating, it must be embedded in and connected directly to the enterprise's strategy. Third, the goal of ERM is to help the enterprise achieve its core objectives.



With a broader perspective of how silo risk management affects enterprise strategic risks, an organization is in a better position to achieve its strategic objectives.

tially launched their ERM efforts out of a compliance function, such as compliance with SOX, emerging privacy legislation, and environmental regulations, among others. More boards and senior executives are now working to shift their ERM approach from a compliance orientation to a *strategic orientation*, consistent with the view that an enterprise-wide approach to risk management should be value enhancing.

### STRATEGIC RISK MANAGEMENT

Boards indicate that this evolving embrace of a more holistic view of risks affecting an enterprise is strengthening their understanding of risks. For example The Conference Board's 2006 study, *The Role of U.S. Corporate Boards in Enterprise Risk Management*, found that many more directors now say they have a better understanding of the major risks facing their companies than they did even two to three years ago. Yet board members still believe they need to have a better handle around issues affecting *strategic risk*. In fact, 53% of the directors surveyed believe strategic risk poses the greatest threat to the company, and only 15.7% see financial risk as their key concern. Thus, there's a growing need for identifying practices that directly and explicitly address strategic risks. (For more about the Conference Board studies, visit [www.conference-board.org](http://www.conference-board.org).)

A large U.S. retailer's recent experience illustrates the importance of connecting risk and strategy. One of the retailer's core strategies was to seek growth through new store expansion. Obviously, events and activities that might significantly affect its ability to add new stores represented risks directly affecting its strategy.

As senior management worked to achieve this strategic goal, they unfortunately discovered that strategies being used at the store level were directly threatening the enterprise's ability to add new stores. Individual store man-

agers were displaying merchandise in store parking lots as part of store promotions, even though those displays violated ordinances in many cities and townships. But because the ordinance violation fines were relatively small, most store managers decided to display the merchandise anyway because of the net profit gained from the visibility.

It wasn't until the retailer sought permits to open several new stores in a large municipality that it discovered this store-level activity was occurring repeatedly across the organization. Before the large municipality would approve new store permits, the retailer had to document a reduction in ordinance violations over a period of several years, which significantly delayed the retailer's ability to achieve its strategic objective of revenue growth through new store expansions in that market.

This example illustrates a growing need for silo risk managers to embrace a more enterprise-wide view of risks related to strategy. With a broader perspective of how silo risk management affects enterprise strategic risks, an organization is in a better position to achieve its strategic objectives.

### INTEGRATING RISK INTO STRATEGIC PLANNING

Successful deployments of ERM in strategic planning seek to maximize value when setting strategic goals by finding an optimal balance between performance goals and targets and related risks. As management evaluates various strategic alternatives designed to reach performance goals, it includes related risks across each alternative in that evaluation process to determine whether the potential returns are commensurate with the associated risks that each alternative brings. At that point, management is in a better position to evaluate various strategic alternatives to ensure that risks that the entity might take on are within the stakeholders' appetite for risk.

## It's important that boards and senior executives focus on external drivers of risk and consider how they might strategically respond to events that might be out of their direct control.

Considering risk during strategy planning also creates an ability to seize risk opportunities. Again, the goal of ERM is to preserve and enhance value. In some situations, ERM may reveal areas where the enterprise is being too risk averse or is ineffectively responding to similar risks that exist across multiple silos of the enterprise. In other situations, ERM may identify risk opportunities that may create potential increased returns to the enterprise. If risks are ignored in strategy, risk opportunities may be overlooked.

A consumer products company's experience illustrates the advantage of connecting strategy and risks. As part of its sales strategy, the company sought to increase revenues by strategically aligning with a key retail customer through electronic reordering systems. As part of this alliance, the consumer products company entered into contracts requiring the automatic shipment of products to the retail customer's distribution warehouses within two-hour increments upon receipt of the customer's electronic reorder purchase request.

As the consumer products company began to launch its ERM processes, senior management quickly discovered a huge potential threat to this strategic arrangement with the retail customer. The company's information technology (IT) disaster recovery processes were set to be within acceptable tolerance limits established by the IT group. In an effort to balance costs with perceived IT needs, the IT group had put recovery procedures in place to fully restore IT-based sales systems within a two-day (not two-hour) period. When core sales executives learned about this recovery time frame, they quickly partnered with IT to reduce recovery thresholds to shorter windows of time. Had they not linked IT's disaster recovery response risks with the sales strategies to fulfill customer orders within two-hour increments, a looming IT disaster could have significantly affected their ability to achieve sales goals,

thus compromising the enterprise's ability to achieve strategic goals. Needless to say, this discovery also prevented other risks that might have been triggered by a disaster, including legal risks tied to contract violations, cash flow losses due to idle sales functions, and reputation risks that could have been realized given the large size and visibility of both the consumer products company and retailer customer.

In the two examples we've presented, internal events created risks threatening the enterprise's strategy. But risks affecting strategy can arise from external events also. As a result, it's important that boards and senior executives focus on external drivers of risk and consider how they might strategically respond to events that might be out of their direct control.

One example of how an enterprise might develop a strategy to address a looming external risk is provided by a large U.S. airline's response to the potential threat of an emerging pandemic illness. As part of the airline's ERM leadership team discussions, senior management identified the risk of a possible pandemic flu or other contagious illness as one that could significantly affect airline passenger volume to such an extent that it might threaten the airline's ability to survive. Management knew that passenger reluctance to fly within the close confines of an airplane cabin would be detrimental if fear of a pandemic outbreak became more real. Furthermore, airline management knew that forces outside its control might restrict or even halt air traffic in the event of a perceived outbreak, much like the shutdown of air traffic after September 11.

Rather than sit idly, hoping such an event might never occur, management sought to interact with key policy setters, including the Center for Disease Control (CDC). While they knew that working with organizations like the CDC might not reduce the risk of a pandemic, management decided that such an alliance would keep them bet-

ter informed of the changes in risk probabilities. Management also hoped their presence at CDC policy discussions would increase the likelihood that any emergency response would incorporate responses appropriately reflecting concerns of the airline industry and the flying public. In the end, although the risk continues to exist, the management team is now better prepared to deal with an event proactively rather than reactively.

## RECOGNIZING STRATEGIC BUSINESS RISK

Strategic risk management can help companies avoid the problem of not recognizing risks soon enough and can help management take swift action to deal with those risks that do occur. What initially appeared to be a minor disruption in the value chain for Nokia and Ericsson in March 2000 turned out to be a critical event for both companies. On Friday, March 17, 2000, a line of thunderstorms appeared in Albuquerque, N.M. A lightning bolt struck a Philips semiconductor plant, causing a fire in a plant that made chips for both Nokia and Ericsson, presenting similar risks to both companies. The fire was minor, lasting only 10 minutes, and the damage at first appeared to be limited, so Philips expected to be back in operation within a week. As it turns out, the disruption to the plant was months rather than weeks, and the impact on production was significant.

Nokia quickly noticed the problem with the supply of the parts even before Philips told them there was a real problem. They took fast action to address the situation once they determined that the potential impact of the disruption in the supply of chips from the Philips plant could translate into an inability to produce four million handsets, representing 5% of the company's sales at the time.

In contrast, Ericsson responded slowly and didn't have alternative sourcing options. By the time management realized the extent of the problem, they had nowhere else to turn for several key parts. This partly stemmed from the company's strategy in the mid-1990s, when it simplified its supply chain to cut costs and in the process weakened its supply backup. One manager at Ericsson said: "We did not have a Plan B." Underestimating the risk of the disruption in supply from the Philips plant and being unable to manage the problem were major factors that led to Ericsson exiting the phone headset production market in 2001. (For more about this example, see "Trial by Fire: A Blaze in Albuquerque Sets Off Major Crisis for Cell-Phone Giants" in the January 29, 2001, issue of *The Wall Street Journal*.)

## EVALUATING STRATEGIC BUSINESS RISK

The first step in strategic risk management is finding a way to systematically evaluate a company's strategic business risk. That has to begin with defining the entity's use of the term "risk." Michael Porter's definition in his landmark book, *Competitive Strategy*, is useful: "Risk is a function of how poorly a strategy will perform if the 'wrong' scenario occurs." Thus, strategic risk management begins by identifying and evaluating how a wide range of possible events and scenarios will impact a business's strategy execution, including the ultimate impact on the valuation of the company.

Before management can effectively manage risks that might be identified by various scenario analyses, they need to define an overriding risk management goal. Otherwise, they won't be able to appropriately determine whether identified risks are within acceptable tolerance levels. The Return Driven Strategy framework (see p. 30) is an effective tool for integrating strategic goals and risk management goals. This framework describes how an enterprise's strategy can be aligned with the ultimate objective to "Ethically Maximize Shareholder Wealth." This is a valid goal for a business entity: to create shareholder wealth, to strive to maximize it, and to do so while adhering to the ethical parameters of stakeholders and communities. (For more, see "What Is Return Driven Strategy?" by Mark Frigo and Joel Litman in the February 2002 issue of *Strategic Finance*, and "Performance Measures that Drive the First Tenet of Business Strategy" by Mark Frigo in the September 2003 issue.)

That ultimate strategic goal can work simultaneously as the entity's risk management goal as well. That is, management must understand, define, and then align risk management activities toward ethical shareholder wealth creation objectives. In doing so, risk management activities must be justified in terms of shareholder wealth creation. If wealth preservation or creation isn't linked to risk management activities, then particular risk management activities should be challenged.

We believe that, to be effective, a framework for strategic risk management needs to include these three characteristics:

**Alignment with a Commitment to Ethically Maximize Shareholder Wealth.** Risk management must have a strong alignment with creating and protecting shareholder value. Rule No. 1 of strategic risk management should read: "First, don't destroy shareholder value." But to add value, strategic risk management should be firmly aligned with the creation of shareholder wealth and have a focus

# The Return Driven Strategy Framework

Mark L. Frigo and Joel Litman

The Return Driven Strategy framework describes strategic activities that have been shown to drive superior performance and describes the hierarchy of strategic activities of best-performing companies in terms of financial impact and shareholder value. It is the result of nearly a decade of extensive research and application involving the study of thousands of companies and the identification of traits and strategic activities that separate the best performers from others.

The Return Driven Strategy is composed of 11 Core Tenets and three Foundations that together form a hierarchy of interrelated activities that companies must perform to deliver superior performance. These Tenets and Foundations summarize the common activities of high-performance companies and can be used to identify flawed strategies of marginal performers. Here is a summary of the 11 Tenets and three Foundations of Return Driven Strategy.

## 11 TENETS

### THE COMMITMENT TENET:

#### 1. Ethically Maximize Wealth

Management must understand, define, and then align activities

toward ethical shareholder wealth creation objectives and ensure that the business operates within the ethical parameters of its constituents and communities.

### TWO GOAL TENETS:

#### 2. Fulfill Otherwise Unmet Customer Needs

#### 3. Target Appropriate Customer Groups

To avoid commoditization, management must focus on fulfilling otherwise unmet customer needs. The path to business success is through the customer—sufficiently large enough groups of customers. This means targeting economically profitable customer groups that have sufficient size and growth opportunities while fulfilling otherwise unmet needs that aren't commoditized and where the organization has unique capabilities (which we call Genuine Assets) to establish a defensible market position.

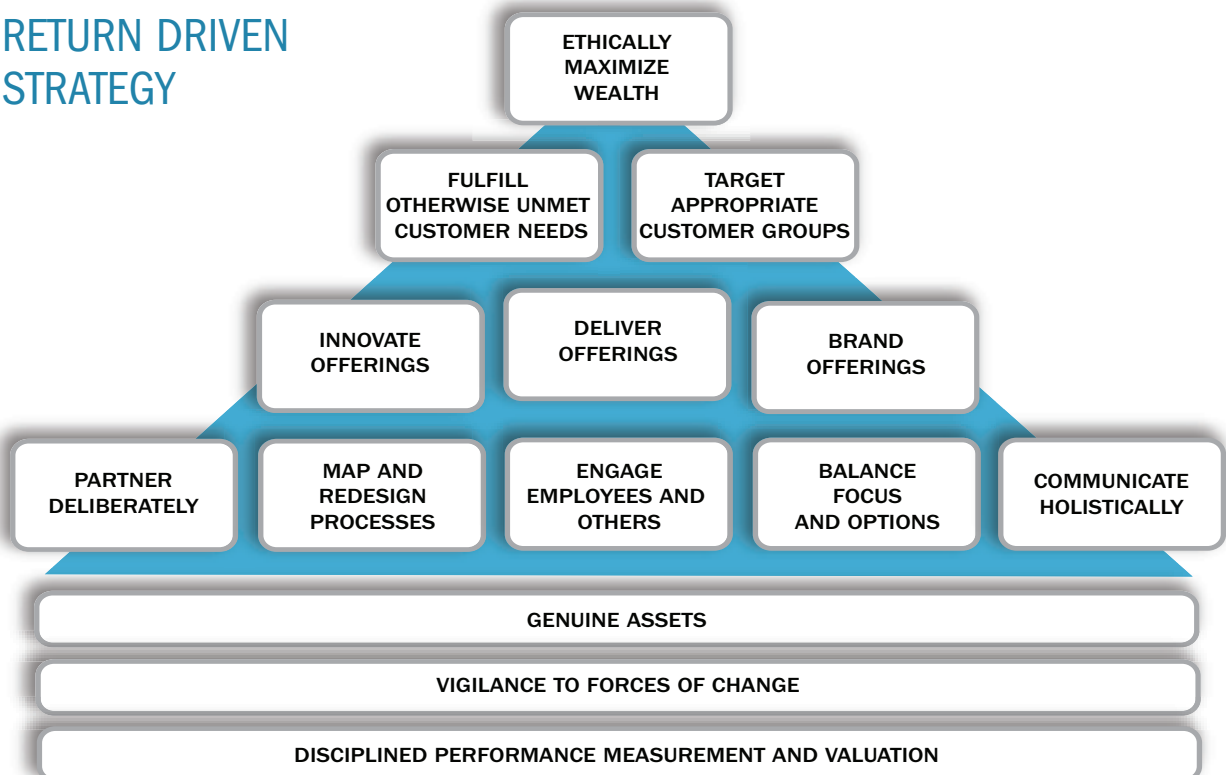
### THREE COMPETENCY TENETS:

#### 4. Deliver Offerings

#### 5. Innovate Offerings

#### 6. Brand Offerings

## RETURN DRIVEN STRATEGY



Version 7.2

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Through synchronization of these three Competency Tenets, offerings are created that target customer needs. Management needs to consider the *executability* of plans at the outset, aimed at achieving the Goal Tenets and Commitment Tenet. A company must constantly reexamine its products and services (its offerings), modifying existing ones and developing new ones that will fulfill customers' unmet needs. At the same time, it must make the connection between the product or service offerings and the customer needs (brand the offering).

#### **FIVE SUPPORTING TENETS:**

**7. Partner Deliberately**

**8. Map and Redesign Processes**

**9. Engage Employees and Others**

**10. Balance Focus and Options**

**11. Communicate Holistically**

The supporting activities are done to support the achievement of the higher-level Tenets: the Competency Tenets, Goal Tenets, and Commitment Tenet.

### **THREE FOUNDATIONS OF RETURN DRIVEN STRATEGY**

**1. Genuine Assets**

The 11 Tenets are the “verbs” of strategy, and Genuine Assets are the “nouns.” Genuine Assets are the building blocks of sustainable competitive advantage. A company’s activities are copied by competitors, which leads to price competition and reduced cash flow returns. This situation can be defended only by leveraging unique assets and capabilities to create unique offerings that can’t be copied (patents, brands, economies of scale and scope, organizational capabilities, unique processes, customer relationships and intelligence, etc.).

**2. Vigilance to Forces of Change**

An organization must have the ability and agility to capitalize on opportunities and avoid threats. Management must take advantage of opportunities and avoid threats in each of the Tenets arising from government, legal, and other regulatory change; demographic and cultural shifts; and scientific and technological breakthroughs.

**3. Disciplined Performance Measurement and Valuation**

An organization must have disciplined performance measurement systems that link strategy to ultimate financial results and that measure the achievement of strategic goals. Performance measures must be in place to support the achievement of the strategy and the resulting shareholder value creation.

on risk opportunities (e.g., the “upside” of risk). Of course, shareholder wealth should be created within the ethical parameters of the constituents and the communities in which the company operates. Any framework for strategic risk management should have the ability to make the connection among the strategy of the organization, its execution and related risk management, and the valuation of the entity. (For more about this, see “When Strategy and Valuation Meet: Five Lessons from Return Driven Strategy” by Joel Litman and Mark Frigo in the August 2004 issue of *Strategic Finance*.)

**Holistic.** Strategic risk management should be holistic and broad enough to encompass the spectrum of entity-wide activities needed to achieve an organization’s strategy. A framework for strategic risk management needs to be integrated so that various facets of strategic business risk can be linked with the overall goals of the business. This is where an ERM approach to risk management helps provide value through its emphasis on viewing risk-related scenarios using a top-down, holistic portfolio approach to determining how various silo risk events might interact to limit or destroy value. A holistic approach to strategic risk management helps connect various business unit goals and objectives and related risks to the overall goal of maximizing shareholder wealth. Without a holistic view, strategic activities within one aspect of the enterprise may be creating strategic risks for another part of the business.

**Capable of Identifying and Evaluating Events and Forces of Change.** Strategic risk management has to be an ongoing, continual process. It can’t be an activity that happens only occasionally. Risks are constantly evolving, which means an organization’s strategies may need to evolve as well, so effective strategic business risk management must be capable of regularly identifying and evaluating how events, scenarios, and forces of change will impact the business strategy and its performance. Robust management scorecard reporting systems that include key strategy and risk management metrics can help strengthen management’s effectiveness at staying on top of key changes that may impact the entity’s strategic goals.

### **A FRAMEWORK FOR STRATEGIC RISK MANAGEMENT**

The Return Driven Strategy framework can be useful for strategic risk management. This framework fully describes the business strategy and activities that drive great financial performance and makes the connection between strategy and valuation. Executive teams have

*continued on page 53*

used it as a holistic framework to set, evaluate, refine, and execute strategy. It also has been integrated into strategic planning processes and used as a way to evaluate the impact of events and scenarios, including merger-and-acquisition scenarios, on a strategy's performance. As directors and management have used the framework to evaluate the business strategy, they have been able to hone in on key risks that could destroy shareholder value while considering the upside of risk in terms of the opportunities, thereby using it as a strategic risk management framework.

Now let's view some of the examples mentioned earlier through the lens of the Return Driven Strategy framework.

**Merchandise Displays in the Parking Lot:** The example of the large retailer shows the importance of aligning employee engagement and incentives with the overall higher-level growth strategy of the company, which is consistent with Supporting Tenet #9 in the framework. Failure to align the activities of store managers can have dramatic effects, even though unintended, on the growth strategy of the company as reflected in the two Goal Tenets and on the ability of the company to create shareholder wealth in the Commitment Tenet.

**Two Hours vs. Two Days:** The example of the consumer products company discovering a mismatch between IT standards and promised customer standards is a great example for the necessity to "Deliver Offerings," which is the "heart of strategy" as Tenet #4 in the Competency Tenets and includes attention to executability. This example also shows the importance of Tenet #8, "Map and Redesign Processes," to ensure that offering is delivered as promised. In this case, the company showed the ability to identify and manage the risk before any significant impact occurred.

**The Thunderstorm:** The example about Nokia and Ericsson provides a great contrast in the strategy and the implicit strategic risk management of each company. Nokia demonstrated effective strategic risk management consistent with the five Supporting Tenets of the framework (Tenets 7-11) through its strong partnering relationships, managing processes in the value chain, engagement of employees and others (including Philips, its supplier), options thinking, effective strategic communication (both internally and externally), and a deep knowledge and insight about the supply chain vulnerabilities (a valuable Genuine Asset) and how to redesign its

value chain in this type of situation. Management at Nokia identified alternative sources of chips, encouraged the dissemination of bad news, took immediate action to monitor the supply of critical parts, leveraged its relationships with other chip suppliers, and benefited from its modular engineering design that enabled use of chips made by other suppliers.

**The Pandemic Threat:** Not only does the airline example of partnering with the CDC demonstrate effective execution of the Supporting Tenets, but it also illustrates the importance of the second foundation of the Return Driven Strategy: "Vigilance to Forces of Change." The airline's partnering with the CDC demonstrates an effective vigilance toward managing the forces of change that might arise from external events, including government responses to emerging health threats and other scientific discoveries.

## THE POWER OF STRATEGIC RISK MANAGEMENT

The alignment of strategic risk management with a strategy framework, such as the Return Driven Strategy framework illustrated in this article, can enable directors and management to manage enterprise-wide risks more effectively by focusing on risk management activities that ultimately protect or create stakeholder value. Strategic risk management can provide a powerful force for continuously evaluating business strategy and proactively developing countermeasures for dealing with the risks that constantly threaten the achievement of enterprise strategic objectives. The explicit linkage of risk and strategy should become an integral part of an organization's strategy-setting process to help protect and create shareholder value. ■

*Mark S. Beasley, Ph.D., CPA, is director of the Enterprise Risk Management Initiative and professor of accounting in the College of Management at North Carolina State University in Raleigh, N.C. Mark is a COSO board member and a leading expert in enterprise risk management. You can reach Mark at [mark\\_beasley@ncsu.edu](mailto:mark_beasley@ncsu.edu).*

*Mark L. Frigo, Ph.D., CMA, CPA, is director of The Center for Strategy, Execution, and Valuation in the Kellstadt Graduate School of Business and Ledger & Quill Alumni Foundation Distinguished Professor of Strategy and Leadership in the School of Accountancy at DePaul University in Chicago. He is a leading expert in strategy design and strategic risk management and is a research fellow in the North Carolina State University ERM Initiative. Mark and Joel Litman are the co-creators of the Return Driven Strategy framework. You can reach Mark at [mfrigo@depaul.edu](mailto:mfrigo@depaul.edu).*