Performance/Risk Integration Management Model – PRIM²

The Convergence of Corporate Performance Management and Risk Management
Introduction

Whether a company is rapidly growing, focused on establishing sustainable competitive advantage or improving its bottom line, it must consider how an integrated approach and discipline to deploy strategy while also anticipating and managing the associated opportunities and risks will improve its probability of achieving strategic objectives. This white paper provides a framework for integrating strategy, risk and performance management. Specifically, it discusses:

- Effectively communicating and deploying strategy in a consistent manner enterprisewide;
- Proactively identifying and mitigating the risks inherent in the strategy;
- Ensuring the seamless integration of strategic plans, risk management and performance management in the execution of the strategy; and
- Real-time transparency into the operations of the enterprise.

When the strategy is made more robust and realistic through the consideration of the underlying risks and its execution is effectively measured and monitored, management and the board of directors will have increased confidence that shareholder value will be not only created, but also protected. This critical balance enhances corporate performance management and positions the enterprise to become an early mover.

CURRENT CHALLENGES

Most organizations today are facing a volatile and increasingly complex operating environment. The scale, pace and impact of globalization, new competitive threats, recessionary pressures, and toughening regulatory demands are unprecedented and are making the simultaneous execution of strategy and management of risk extremely challenging. In those organizations where strategic and risk management activities are still conducted in isolation and where risk is a mere afterthought to strategy-setting, the results can be disastrous.

The subprime crisis and the ensuing meltdown in the financial markets have culminated in attempts by the Obama administration and Congress to address the situation to stave off the threat of a paralyzing credit crunch. The financial crisis of 2009 is a good example of what can happen when the inherent risks associated with aggressive, growth-oriented market strategies are discounted, ignored or possibly never even considered. Industry losses from subprime mortgages are expected to be in the hundreds of billions of dollars, with nearly 50 percent of risky home loans going into default. The root causes were many – failure to monitor critical assumptions underlying the business model, breakdowns in time-tested underwriting standards, failures to provide or obtain adequate disclosures, excess reliance on flawed rating agency assessments of structured products, a myopic focus on short-term results, to name a few. But not every financial institution played the subprime game recklessly. Some firms identified the sources of significant risk as early as 2006 and had up to a year to evaluate the magnitude of the risk and implement cost-effective plans and appropriate exit strategies.
to reduce their exposure. Skeptical of rating agency assessments, others refocused their own in-house expertise to assess credit quality. Some even tested their assessments by selling a small percentage of high-risk assets to obtain reliable pricing data points to drive informed decisions.

These and other actions resulted in a significant redirection of market focus and gave these firms a seat in the ring when the proverbial music stopped, leaving their unfortunate competitors standing for all to see and scrutinize. The firms that succeeded in minimizing their losses protected enterprise value by engaging in subprime lending with an appropriate assessment of the underlying risk and exercised the discipline to take action to reduce their exposure when it was practical to do so. Not surprisingly, some financial institutions did not engage in subprime lending at all – their underwriting standards did not permit the practice.

The bottom line is clear: Firms that undertook steps to protect their balance sheets or honored the prudent constraints imposed by their long-standing internal policies and processes have placed themselves in a stronger competitive position relative to their weakened peers. If these firms acted before anyone else, they were the industry’s early movers. The other firms that placed enormous bets on the subprime market have destroyed enterprise value that took them years to build. For those institutions that survived and were not acquired by their more risk-savvy counterparts, it will take years for them to recover, rebuild the lost value and restore the luster to their tarnished reputations. Time will tell.

Balancing appropriate protection measures with aggressive value creation strategies can make a difference over the longer term. It has never been more important to align fully and integrate strategy with risk and performance management. At Protiviti, we have coined the term “Performance/Risk Integration Management Model” (PRIM²) to capture this imperative of a differentiating skill that integrates the key elements of strategy execution with risk management and performance management.

PRIM² can be defined as an enterprisewide program that establishes and maintains alignment of strategy, performance management processes and risk management capabilities in a changing operating environment. PRIM² provides an integrated approach and discipline to deploy strategy and manage the associated risks. It places strategy-setting and performance and risk management in a broader strategic context by:

- Communicating and deploying strategy effectively in a consistent manner across the enterprise;
- Proactively identifying, sourcing and mitigating the risks inherent in the strategy and understanding how the enterprise’s risk profile relates to its risk appetite;
- Ensuring the seamless integration of strategic plans, risk management and performance management in the execution of the strategy; and
- Creating real-time transparency into the operations of the enterprise to measure current performance and predict future trends in order to facilitate the alignment of strategy and performance and risk management continuously over time.
While the design and implementation of a PRIM² process and infrastructure will vary from organization to organization, it should include the following core elements, which are aligned with the way an organization’s leadership executes strategy and manages the business.

The above core elements frame both the governance and management processes of an organization. We discuss these elements further on the following pages.

In the PRIM² framework, management’s focus around ASPIRE and PROTECT falls within the context of GOVERN because the board of directors provides the appropriate oversight to ensure that risk is effectively integrated with strategy-setting. The increased emphasis on board risk oversight is placing more demands for a process to support management’s ongoing dialogue with the board. The strategic aspirations, differentiating capabilities and infrastructure needed to deliver those capabilities, as articulated by the strategy, are combined with an understanding of the critical assumptions underlying the strategy as well as the risks inherent in the strategy to provide inputs to the determination of key metrics and targets (AIM). It is at this point where risk management intersects with performance management. As depicted in the framework on the previous page, an ongoing process occurs to execute the strategy and manage the business, beginning with AIM and continuing with PLAN, MEASURE and ACHIEVE, all of which are supported by ENABLE. The core elements of this PRIM² process illustrate how an effective governance process, along with the management process that functions under the oversight and direction of the governance process, should function. The remaining discussion in this white paper addresses each of the core elements of PRIM² and how they interact.
There is a great deal of confusion about what governance really is and its role in developing strategy and managing risk. In the context of PRIM\(^2\), we define “governance” as the establishment and maintenance of a flexible corporate structure that optimizes the balance between the entity’s value creation objectives and performance goals (aspire) with the policies, processes and controls it deems appropriate to preserve enterprise value (protect). This notion of balance is about positioning the organization to attain “early mover” status whenever it arrives at a crossroads where the company’s market position could be harmed significantly if the imminent opportunity is not recognized in a timely manner by the right people and acted upon. Ultimately, this balance is realized through an enterprise management and monitoring capability, commonly referred to as competitive intelligence, that is focused on the key assumptions underlying the strategy and places high priority on preserving reputation and brand image and establishing the early warning capability that lays the foundation for the enterprise to become an early mover. As we define it, an “early mover” is a firm that quickly recognizes a unique opportunity or risk and uses that knowledge to evaluate its options, either before anyone else or along with other firms that likewise recognize the significance of what's developing in the market and seize the initiative. Simply stated, early movers have the advantage of time, with more decision-making options before market shifts invalidate critical assumptions underlying the strategy.\(^1\)

Conceptually, governance is like maintaining control over a complex rail yard operation. Rail yards consist of a large number of tracks grouped for the purpose of disassembling, sorting and assembling cars in a train. Railroads assemble a new train of cars based on the delivery requirements of their customers. The flexibility afforded by these operations facilitates the line's responsiveness.

In the same manner, the governance process addresses multiple moving parts and brings them together. It provides oversight for (a) the formulation of strategy, (b) positioning the enterprise to execute the strategy, (c) balancing the organization's aspirational goals with its appetite for risk, and (d) providing the mechanism to monitor progress toward achieving the risk-integrated strategy by providing appropriate guidelines, policies and parameters for operating the enterprise. Governance focuses on two broad objectives – ASPIRE and PROTECT.

**ASPIRE – Articulating Strategy, Capabilities and Infrastructure**

Research suggests that, on average, companies deliver only 63 percent of the financial performance promised by their strategies.\(^2\) While there are many reasons for this, several common themes have emerged. If strategies are not rooted in sound business fundamentals, the expected results can be unrealistic and overly ambitious. In addition, strategies often are too complex, which makes it difficult to communicate them across the organization. If a strategy cannot be communicated effectively, it does not matter how good it is – no one will understand it, and thus alignment of process and individual performance with the strategy is next to impossible.

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\(^1\) Note that our use of the “early mover” distinction is broader than the traditional focus on “first mover advantage.” The nature of that kind of advantage typically is focused on the initial significant occupant of a market segment, whereas failing to attain “early mover status,” as we’ve defined it, can result in playing out an obsolete business strategy. Issue 7 of Volume IV of *The Bulletin*, “Is Your Organization an Early Mover?”, explains the subject of an “early mover.”

Strategy sets the aspirational direction for the enterprise, meaning it focuses on how the entity will create value for its customers, employees and stakeholders. In selecting a viable strategy, management must consider many variables, including current capability and market position, regulatory and political trends, economic pressures, the reliability of the critical assumptions underlying the strategy, and the risks inherent in the business model required to execute it.

Selecting a strategy comes down to choices. Four important choices are:

- **Destination** – Strategy depicts where the enterprise wants to go to achieve success.
- **Clarity of purpose** – Given the stated destination, strategy requires developing and communicating clear and concise objectives to ensure the appropriate direction is set for the enterprise.
- **Clear linkage** – Strategy facilitates the alignment of corporate-level objectives to the objectives of each unit, process and work group in the organization.
- **Capabilities and infrastructure** – Strategy describes the enterprise’s source of competitive advantage, as expressed through the capabilities and infrastructure needed to execute it successfully.

Destination is often explained through the organization’s vision, mission and values. To provide clarity of purpose and clear linkage of strategy on a top-down basis, the enterprise must be able to describe its strategy clearly and simply. One best practice is implementing a strategy articulation process. Strategy articulation is not about strategy development, although the two are related. Rather, strategy articulation is a method by which the major components of a developed strategy are depicted in a format that can be communicated throughout the organization effectively and easily.

**Case Example:**

Strategic aspirations can be very important, as they often chart a company’s success in the marketplace. While the U.S. automotive industry is facing formidable challenges in today’s market, it is well known that Ford and General Motors fought long and hard for dominance in the U.S. automobile market in the first half of the last century. Ford’s focus was on economies of scale, in which everyone could have a car at a low price; however, everyone would have to drive the same model of car with the same color. General Motors offered something different – flexibility and choice. The company focused on a more adaptable design and production line – a strategy that ultimately led to distinctive branding that would be responsive to changing customer wants. The more flexible strategy resonated with the market. As a result, General Motors gained a greater share of the market in this emerging stage of the industry. That outcome set the tone in the market for several decades into the early 1980s. Since the early 1980s, the impact of foreign automakers has resulted in a steady deterioration of market share for General Motors. This decline in share, as well as other factors, culminated in the company filing for a government-assisted Chapter 11 bankruptcy protection on June 1, 2009, with a plan to re-emerge as a smaller and less debt-burdened organization.

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An articulation of capabilities and infrastructure is important because it provides insight into what the organization does better than anyone else. This articulation may include superior technical or subject-matter expertise, a more reliable and innovative process, proprietary systems, a differentiating brand, close customer and supplier relationships, and a distinctive culture, among other competitive advantages. If competitors lack the entity’s capabilities and infrastructure and have difficulty replicating them, the organization has a source of sustainable competitive advantage.

The output of the strategy articulation process is a Strategy Articulation Map. This map becomes the primary vehicle for communicating strategy to the organization.

Another best practice is strategy visualization. Leveraging technology to visualize the strategic priorities and the interdependencies between those priorities is critical to the effective communication and monitoring of strategy. Strategy visualization provides a natural link to metrics and planning. It should integrate consideration of the critical risks inherent in the strategy.
Corporate strategy is governed by the willingness of an organization to accept risk in the pursuit of value creation, as well as its capacity to bear that risk. Strategy-setting establishes aspirational objectives that drive the design of a business model in which risks are undertaken to execute it. This is a good thing. The business model of every successful organization exploits to the maximum extent possible the areas in which the company excels relative to its competitors. That includes thoughtful selection of risks to take in executing the strategy.

In leveraging these advantages, however, there needs to be a disciplined approach to ensure the company is not recklessly gambling its future. Thoughtful risk-taking requires management to consider plausible scenarios that should be addressed by the plans established for the respective time horizons selected for purposes of strategy-setting, business planning and budgeting. These scenarios can be related to changes in customer preferences, supplier performance, the economy, competitor behavior, regulatory requirements or physical phenomena (e.g., weather, natural disasters). While the occurrence of one or more of these scenarios is often beyond management’s control, an effective strategy can reduce their impact on the business. Because these factors define the operating environment, they can affect earnings, cash flow, and capital adequacy and availability, as well as influence the outcome of performance and achievement of strategic objectives. They require transparency at the highest levels of the organization.

Therefore, the aspirational objectives of strategy-setting must be appropriately balanced to ensure the company is taking only those risks it is best equipped to manage within the parameters of its risk appetite, while minimizing exposure to those risks considered “off-strategy” because of the inability to manage them effectively. The latter risks should be outsourced through effective risk transfer mechanisms.

Strategy-setting and risk assessment, taken together, facilitate the articulation of the critical assumptions underlying the strategy. These assumptions often relate to such things as expected global and domestic economic trends, competitor behavior, changes in the regulatory environment, physical phenomena (e.g., weather), customer behavior, supplier performance, and availability of effective distribution channels. Once these underlying assumptions are understood, management must consider relevant risk scenarios that could invalidate one or more of the assumptions and thereby impact the viability of one or more aspects of the strategy.
This approach raises important questions. For example, does it make sense to take all of the risk an organization is capable of undertaking without reserving capital and resources for new investment opportunities? Does it make sense to ignore clear warning signs about certain aspects of the strategy without consulting the board of directors? Is it appropriate to retain a significant risk when cost-effective options for transferring it to an independent, financially capable party are available? What is the desirable relationship between the capacity to bear risk and the appetite to take risk, and should the strategy be modified to reflect that relationship? The point is this: From a strategy-setting standpoint, it is useful to have a notion of when the organization’s capacity for bearing risk should be encroached upon. This ongoing risk appetite dialogue is one that should take place over time between management and the board as circumstances change and changes occur in the external environment. For this reason, a disciplined approach around protecting enterprise value should be integrated with the aspirational objectives established through strategy-setting.

Case Example:

When a dominant CEO sets out on an aggressive strategy without incorporating industry fundamentals and the appropriate risk management counterweights, it can result in a company paying the ultimate price. Braniff Airways had a long history as a successful regional carrier. When the airline industry was deregulated in the 1970s, Braniff’s CEO undertook a very aggressive growth strategy without apparent regard for what many industry insiders believed to be key fundamental industry practices. Within a matter of a few weeks in 1978, Braniff opened 49 new routes to varying destinations spanning the globe, operating only one daily round-trip and ignoring the time-tested dogma that only frequent service attracts profitable business traffic. For that reason, the traditional practice in the industry was to add perhaps one new route each year.

In the words of a CEO of a rival airline, Braniff’s sporadic global focus “took the hub apart” that it had enjoyed as a regional line, thus eroding the economic advantages of its business model. In effect, Braniff was betting that other airlines would not modify their behavior as a result of deregulation. That assumption proved wrong. Pricing became more competitive and Southwest Airlines began to emerge as a formidable competitor. Some believed that Braniff’s management team was placing huge bets that deregulation would not last and, by snatching up as many routes as possible, Braniff would emerge as a major global carrier. However, the bets Braniff placed on deregulation did not pan out. In the early 1980s, fuel prices were increasing just as Braniff was acquiring fuel-hungry 747s while other airlines were trying to dump them. The American public, feeling the effects of a recession, were not flocking to airports. Burdened with heavy expansion debt and empty flights, Braniff ceased operations in 1982.

Many organizations do not integrate risk management planning with strategy development. That is a mistake. It is critical to define the soft spots, loss drivers and incongruities that are inherent in the enterprise’s strategic objectives and that could dramatically affect performance and adversely impact execution of the strategy. These are the risks that really matter. Once the pertinent risks are identified, the amount of risk an enterprise is willing to accept in pursuit of the strategy – its risk appetite – is defined. As noted above, the concept of risk appetite is important to setting the boundaries for the broad risk-taking activities of an organization. More specific risk tolerances are then defined to facilitate monitoring of the effectiveness of the enterprise’s responses to key risks.

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Risks and risk tolerances are addressed in the following manner:

(1) Create an effective process for the enterprise to facilitate identification of the risks that are most relevant to achieving its strategic objectives. The Protiviti Risk Model\textsuperscript{SM} is a comprehensive framework that enables the process of identifying and prioritizing the organization’s business risks:

A customized risk model establishes a common language for discussing business risks.\textsuperscript{5} It can serve as a basis for codifying, mining and aggregating risk data to make the evaluation and tracking of risks much more effective and efficient.

(2) Using the risk model, design an enterprise risk assessment process to identify and source those risks that matter most, given the strategy and the enterprise’s appetite for risk. While all risks can have an impact on the strategy, as defined by management, and there are probabilities associated with whether or not they will transpire, there are important differences that distinguish them. For this purpose, it may be useful to segregate risks into appropriate categories to consider fundamentally different characteristics that should be considered when understanding them. The above risk model illustrates appropriate categories of risk. Other categories might be strategic, operational, financial and compliance, each of which can be reconciled to the above model. For example, strategic risks might include environment risk and strategic information for decision-making risk.

(3) For high-priority risks, establish tolerances consistent with the overall risk appetite. The risk tolerance establishes the parameters for a specific risk. It is measured with the same unit of measure that is used to monitor the achievement of objectives. Taken together, the organization’s risk tolerances provide assurance to management and the board of directors that the organization remains within its risk appetite.

\textsuperscript{5} Along with the proprietary risk model shown above, Protiviti also has developed industry-specific risk models. Visit www.protiviti.com for more information.
Consider the railroad example cited earlier. Assume the railway sets an objective around on-time service. Assume the industry average for on-time arrival at destinations is 76 percent. Assume further that the railway’s historical target has generally been 84 percent and that the cost to achieve 88 percent is not economically feasible and cannot be passed through to the customer. Based on this information, management sets the performance objective at 84 percent, with a tolerance of between 82 percent and 87 percent. This approach allows for communication of the level of variation that management is willing to accept around the achievement of the railroad’s on-time objective.

Because compliance is an important category of risk, it is imperative to assess compliance requirements and their inherent risks. Compliance relates to the risk that external laws and regulations, as well as internal corporate policies and procedures, are not followed and that such noncompliance could hinder or prevent execution of the strategy. Therefore, an inventory of compliance requirements should be developed and used to identify and rank corporate compliance requirements that must be met to execute the strategy and minimize compliance risk. When developing a corporate strategy, automated mechanisms aiding in the evaluation and monitoring of compliance performance are among the keys to successful execution by aggregating component requirements and activities efficiently and effectively.

In summary, the focus on PROTECT drills down from the enterprise’s mission, its differentiating capabilities, its objectives made possible through its differentiating capabilities, the critical assumptions underlying the strategy and the risks inherent in its objectives. At this point, we can now begin to understand how risks, and the enterprise’s responses to them, can impact the strategy.
Once the strategy has been set along with the corresponding assumptions, and the enterprise risks have been identified using strategic risk assessment or scenario analysis, management is ready to initiate the actions necessary to put in place the differentiating capabilities that will achieve the objectives outlined in the “balanced strategy.” Using the Strategy Articulation Map, the risks can be linked clearly to strategic objectives. Again using our railroad analogy, as illustrated below, aging tracks have a direct impact on a market differentiator – speed. The combination of strategic execution and risk mitigation plans enables management of the railroad to take specific actions that would not otherwise be taken, resulting in a more realistic and robust strategy that enhances the likelihood of successful execution.

The key risks and critical assumptions underlying the strategy are now more transparent and better understood. This knowledge of key risks and assumptions, along with the strategy itself, provides inputs to the determination of key metrics and targets. As noted earlier, this is the point where risk management begins to integrate with performance management. This integration provides a valuable context for driving strategic execution and the management of the business. More importantly, it makes possible better anticipation through the use of a balanced mix of lead and lag indicators.

One of the more critical management functions is the allocation of capital. Many competing initiatives, agendas and priorities make a truly enterprisewide approach to allocating the necessary capital to support the overall strategy difficult and contentious at times. By taking an approach to require requests for capital to consider both the strategic benefits and the risk management costs, along with any residual unmitigated exposures, management can ensure the process is more transparent and objective and results in a more thorough business case.

The emphasis on integration is vital to effective corporate performance management. As we move to MANAGE, it becomes evident that a focus on integration of strategy execution and risk management can lead to value-added improvements to the processes of (a) selecting key drivers, metrics and targets; and (b) budgeting and planning. These areas are detailed below.
MANAGE – MAKING INTEGRATION PAY OFF

We’ve discussed the core elements of the PRIM² framework relating to an effective governance process. We now discuss the elements relating to the management process that functions under the oversight and direction of the governance process.

AIM SETS THE KEY METRICS AND TARGETS THAT TRANSLATE STRATEGY AND RISK APPETITE INTO PERFORMANCE EXPECTATIONS SO THE ORGANIZATION CAN REACH ITS RISK-ADJUSTED ASPIRATIONS.

AIM – Defining the Metrics that Matter

Linkage of strategic objectives to the key drivers of value is critical to the successful deployment of strategy. Value drivers are those factors that positively or negatively impact a company’s ability to execute its strategy and create economic value. These value drivers form the basis for selecting the key metrics and targets, and also should consider drivers of risk and an enterprise-wide view.

As stated earlier, PROTECT drills down from the enterprise’s mission, its capabilities, its objectives and the risks inherent in its objectives. Aiming an organization’s attention, resources and commitment starts at the same place, but ultimately progresses to value drivers to articulate the key processes and their expected outputs (performance). The metrics selected must enable the organization to track progress toward the achievement of strategic objectives, mitigation of risks, and compliance with internal policies and external regulations. Traditional key performance indicators (KPIs) and key risk indicators (KRIs) should converge to create a single basket of metrics. KPIs are measures of performance developed to monitor progress toward the achievement of strategy and the ultimate creation of value for stakeholders. KPIs are the primary means for communicating business results across an organization. KRIs provide leading and lagging indicators for critical risk scenarios, resulting in a more balanced mix of forward-looking indicators to complement the usual metrics around customer satisfaction, quality, innovation, time and financial performance. For example, in our railroad example, accumulated deferred track maintenance may be a lead indicator of future on-time arrival issues.

Therefore, the process is one of first identifying the value drivers and then selecting the metrics that reflect those drivers. The process of identifying the right metrics begins with understanding the market differentiators articulated by the strategy and business model for delivering those differentiating capabilities to the market. The key financial components of value in the business are decomposed so that they can be linked with the critical business processes and strategic objectives. This strategic linking process, or “value decomposition,” identifies the major drivers of performance in the business. By taking these steps, management can be assured that the selected metrics are linked to both the strategy and the creation of value. In some instances, a given value driver will be a relevant metric. In others, the metric will need to be developed to reflect the value driver.
For example, using the value drivers noted in the railroad illustration, the following metrics may be developed.

<table>
<thead>
<tr>
<th>Value Driver</th>
<th>Potential Key Metric</th>
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<tbody>
<tr>
<td>Price</td>
<td>Average revenue per car load</td>
</tr>
<tr>
<td>Volume</td>
<td>Car load volume to plan</td>
</tr>
<tr>
<td>Mix</td>
<td>Margin per car load</td>
</tr>
<tr>
<td>Loading efficiency</td>
<td>Average loading cycle time</td>
</tr>
<tr>
<td>Compliance with safety regulations</td>
<td>Safety incident rate</td>
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</tbody>
</table>

Before metrics can be finalized, they must be screened to ensure they meet the requirements of a key indicator versus an operating or financial statistic. To be selected as a key indicator, the metric must possess all seven of the characteristics listed below:

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Linked to strategic objectives, key risks and value drivers</td>
<td>Can the measure be aligned with an objective, key risk and driver of value?</td>
</tr>
<tr>
<td>Controllable or influenceable</td>
<td>Can the results be controlled or significantly influenced by the enterprise?</td>
</tr>
<tr>
<td>Actionable</td>
<td>Can action be taken to improve performance and further mitigate risk?</td>
</tr>
<tr>
<td>Simple</td>
<td>Can the measure be easily and clearly explained?</td>
</tr>
<tr>
<td>Credible</td>
<td>Is the measure resistant to manipulation?</td>
</tr>
<tr>
<td>Integrated</td>
<td>Can the measure be linked both down and across the organization?</td>
</tr>
<tr>
<td>Measurable</td>
<td>Can the measure be quantified?</td>
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</table>
Value drivers are segregated between predictive drivers and output drivers. In our railroad example, aging tracks are a key factor that is highly relevant to the “Transport” driver. Therefore, management should develop a KPI and a KRI for this key factor. In this way, value drivers become a critical input into the development of key measures and targets:

As discussed earlier, the railway sets an objective around on-time service. Management sets the performance objective at 84 percent, with a tolerance of between 82 percent and 87 percent. While this tolerance might be viewed as a performance tolerance, it is also a surrogate KRI to address the risk around aging tracks, which affects the railroad’s ability to achieve its on-time performance target. As noted earlier, a more direct KRI might be around adherence to track maintenance schedules, for example, the occurrence of track maintenance deferrals. The point is twofold: First, value drivers and the related performance tolerances (KPI) have risks associated with their achievement. Second, these risks should be identified and tolerance levels established, from which a KRI can be established. This connectivity between a value driver and a relevant KPI and KRI is an important bridge from a strategic view of risk – which can have a time horizon of three or more years – to a more focused budgetary view of risk, which is often applied to a single year.
AIM – Setting Targets

Once the metrics have been screened and finalized, the target-setting can begin. Target-setting for each key indicator should include five critical inputs.

<table>
<thead>
<tr>
<th>Input</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Past performance</td>
<td>How have we done historically?</td>
</tr>
<tr>
<td>Internal benchmarks</td>
<td>How is high performance defined internally?</td>
</tr>
<tr>
<td>External benchmarks</td>
<td>How is high performance defined externally?</td>
</tr>
<tr>
<td>Strategic alignment</td>
<td>Performance expectation as it relates to strategic intent?</td>
</tr>
<tr>
<td>Risk tolerance</td>
<td>Parameters of performance given the risk appetite of the enterprise?</td>
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</table>

Management should avoid setting targets in a vacuum or without rigor, as that behavior can lead to overly ambitious goals or targets that do not align with the strategy or risk profile of the organization. Targets should also be set and/or coordinated on an enterprisewide basis. Setting targets in silos or on a functional level can lead to suboptimal results.

Targets should be established to accommodate expectations for achievement. Typically, short- and long-term targets are set. Once this has been done, metrics can be cascaded down through the organization to the appropriate levels. This approach vastly improves the chances of strategic alignment. A common mechanism for communicating the metrics throughout the organization is a performance dashboard.

The key indicators, as well as the value drivers and risk drivers used as input, are composed of raw data residing in various sources and in various forms. The data may be housed in multiple areas both within the organization (e.g., revenue) or in external sources (e.g., competitor revenue). Particular attention should be given to whether the data is up-to-date and valid. The quality, source and latency (the time delay between the moment something occurs and the moment it can be reported) of the data used will influence significantly whether the seven characteristics (see page 10) for each metric are met. Quality, source and latency also will ensure the targets determined by management are viable and the benefits of performance planning and execution are realized.
The Convergence of Corporate Performance Management and Risk Management

Integrated business plans establish the roadmap for achieving performance expectations and driving the tactics and actions required to implement that roadmap.

PLAN – Integrating the Planning Process

Integrated business planning provides a comprehensive framework to deploy and execute corporate strategy across an organization in concert with planning, budgeting and resource allocation. In many organizations, these are separate, individual processes, often championed by different parts of the organization. To be truly integrated, performance planning must incorporate the enterprise’s responses to key risks. In effect, the planning process must link strategic planning with risk mitigation planning, budgeting, forecasting, resource allocation and the reward system.

Performance plans describe the steps required to achieve the strategic objectives and reach the targeted levels of success. This process is repeated to cascade the strategy down through the organization. In this way, the integrated process decomposes corporate strategy into effectively articulated performance plans that are supported by specific policies (including limits), procedures and integrated key metrics to establish clear management accountability for execution.

Budgets in any organization should provide the resources required to achieve the desired strategy, manage the critical risks, and maintain compliance with laws, regulations and internal policies. In integrated planning, budgets are developed based on objectives and actionable plans along with risk responses to establish accountability for results. The budgets, plans and key metrics for each group are rolled up to the top level of the organization, checking for integration and alignment between the plans, both within and across the organizational hierarchy. We maintain the linkage between the plans, budgets, KPIs and KRIs to ensure the budgets remain integrated with the performance expectations they are intended to support.

Resource allocation in many companies is perhaps the most political of all management processes. Integrated planning changes the game of resource allocation to focus more on meeting the overall needs of the organization to achieve the strategy and manage risks within the organization’s risk appetite. Resources are allocated based on the stated goal of achieving the corporate strategy through the budgets supporting execution of performance plans.

Case Example:

The pursuit of functional excellence can lead to unintended consequences for the entity as a whole. To illustrate, in the 1990s the purchasing function of Ford Motor Company set out to reduce the risk of significant price increases in certain rare metals – platinum, palladium and rhodium – used to produce the catalytic converters that had been included in automobiles for many years. The department entered into a series of long-term contracts to purchase these rare metals at fixed prices to lock in the price and preserve operating margins. This is exactly what a competent purchasing function should do.

While procurement was doing its job to manage costs, Ford’s research and development function undertook a different approach to addressing the problem. They designed a different version of the catalytic converter that obviated the need for the huge inventories of the metals Ford had committed to purchase. In addition, the market for the metals changed, leading to an oversupply that drove significant price reductions – a scenario that was exactly opposite of what the company had expected. The impact was not good. Ford’s financial statements took a hit of almost $1 billion to reflect the loss on its long-term purchase commitments.

The reward system is an integral part of the business planning process. In today’s fishbowl environment where shareholders and politicians alike are focusing on compensation as if it were a lightning rod, it is critical that compensation be linked to performance and effective execution of the strategy. If there is a lesson to be learned from the financial crisis, it is this: Compensation needs to be adjusted for risk, and generous severance packages that reward failure can lead to embarrassment. The goal should be fairness to both the executives in question and to shareholders. From a shareholder’s perspective, the key to fairness is to align the executive’s rewards with long-term performance, with appropriate provisions for deferred compensation, vesting and clawback protections. The compensation structure for the CEO, his or her executive team and the “star system” must be effective in aligning performance with a longer-term corporate strategy and must not be unduly weighted to “making numbers” for the current year.

The message on integrated planning is this: The strategy is best deployed at the level of greatest achievability and accountability and engages the appropriate managers with the resources required to get the job done. Business plans and budgets must reflect the risk strategies and capabilities (policies, processes, reports and systems) needed to address the underlying risks.
MEASURE CONSISTENTLY AND CONTINUOUSLY EVALUATES PERFORMANCE RESULTS AGAINST TARGETS.

MEASURE – Monitoring and Evaluating Performance

Performance monitoring and evaluation can be defined as the consistent and continuous reporting and feedback of performance results against targets. This process determines the effectiveness of performance plans and the ultimate creation of value within the enterprise’s appetite for risk and established strategic boundaries.

Effectively, performance monitoring gives the organization the ability to measure the rate of progress it is making toward its strategic objectives and the mitigation of its critical risks. The focus is on the established KPIs and KRIs. Monitoring also includes an ongoing evaluation of risk responses and compliance processes. The rate of progress is a direct reflection of the effectiveness of established plans and how well they are being executed. Performance monitoring institutionalizes the performance management program as the primary means of dialogue for discussing business results using a common language. It ultimately allows management to focus on important strategic and operational issues with sufficient clarity and insight.

The monitoring process must incorporate the capability not only to track actual results against metric targets, but also to drill down to gather information on exceptions and performance variations. This capability requires an information hierarchy that is able to gather, consolidate and configure data quickly in a manner that provides information relevant to proactive management of company performance.

**Real-Time Analytics** – The definition of real-time analytics varies by organization, but at its heart is the necessary latency of information required to achieve competitive advantage. This capability can mean data is updated four times a day for one company, or is immediately updated as events occur for another company.

With the proper performance and risk metrics in the hands of decision-makers, it becomes possible to act on information as soon as events occur. If a rail facility goes offline, planned shipping numbers immediately drop below thresholds and alerts are broadcast. Alternate facilities can be activated to fulfill the existing variance, and the related metrics return to balance. Improvements in data latency create a fundamentally agile and proactive organization, reducing the ongoing gap between an event occurrence and any necessary actions.

Utilization of a balanced scorecard or dashboard becomes the focal point for monitoring and evaluating business results (i.e., the common language). The balanced scorecard or dashboard should be supported by capabilities such as trending, exception reporting, predictive versus output key metric comparisons and action planning.
ACHIEVE REALIGNS STRATEGY AND TACTICS WHEN NECESSARY TO MEET OR EXCEED PERFORMANCE EXPECTATIONS.

ACHIEVE – Realigning, as Needed, and Achieving Results

The one thing we know for certain is that plans are not perfect and the execution of those plans often runs into barriers or goes off track. When plans are not effective in articulation or in execution, performance is usually suboptimized. At this point, changes should be made to the plan, tactics, resources allocated or some combination of these. This realignment process allows the enterprise to identify pockets of subperformance rapidly and proactively take corrective action, which might include budgetary adjustments, redirection of resources, remediation of controls, process improvements, cessation of certain activities and other tactical actions.

Monitoring actual results to targets should include built-in tolerances that indicate the need for changes in capabilities and/or infrastructure if results are approaching or are out of tolerance. Corrective action should be taken when out-of-tolerance results occur. Such action can involve issues tracking, change management and even crisis management. Also, top-down strategic reviews should be conducted on a periodic basis to ensure that plans, including risk responses, are still relevant given changes in the environment.

Case Example:

Realignment of strategy and tactics is vital in an evergreen operating environment. Companies can and do recover from aggressive strategies that do not perform as intended. For example, McDonald’s growth strategy in the late 20th century was measured by new restaurants, expanded menus and the “billions and billions served.” However, the singular focus on top-line growth resulted in a decline in average revenues per restaurant and overall operating margins, which ultimately netted the company its first-ever quarterly loss in 2002. As a result, McDonald’s modified its strategy to manage its operational risk by focusing on cash flow and operational excellence. The company’s enhanced growth strategy ended up increasing corporate revenues in more than 45 consecutive months. The good news is that the company ended up in the right place with the right focus.

ENABLE – Establishing a Corporate Performance Management Platform

PRIM² requires a technology platform that can enable effective and timely business planning, initiative tracking and performance measurement. It’s highly unlikely that a single software package can effectively address all of an organization’s reporting needs. Some of the necessary software solutions may already be in use for other informational needs, such as financial consolidations; budgeting, planning and forecasting; and data warehouses. It is important to leverage these data and information aggregation tools while addressing additional needs with new technologies in other areas, such as balanced scorecards and advanced analytics and modeling. The concept of establishing foundational information layers is further illustrated by Protiviti’s Information Hierarchy model (see below).

As the organization progresses up the above Information Hierarchy, it improves its performance management capabilities. At the top of the hierarchy is the “Early Mover Enterprise.” While everyone talks about performance management being a vital tool for aligning processes with strategy and keeping performance on target over time, we suggest that it is also about positioning the organization to become an early mover. The integration of performance and risk management on matters of strategic importance is where corporate performance management often fails, leaving the organization unable to implement an effective competitive intelligence function that monitors the vital signs and anticipates emerging opportunities and risks.

The technology alternatives for enabling progression up the hierarchy are vast, but without incorporating the right data with the highest quality, the result will be frustrating and disappointing at best. For example, it could possibly cause inappropriate actions that adversely affect achievement of the strategy. Or it could create formidable obstacles for competitive intelligence processes to recognizing the trends and patterns that facilitate the identification of early mover options. The point is that, as the metrics derived from established KPIs and KRIIs move from vision to reality using a robust technology platform, there are two key considerations:

1. Are the data sources correct?
2. Is the data valid and timely?
Information Sourcing – In our railroad example, if 10 different people are asked where to find the monthly rail car volumes, there likely will be 10 different answers. To ensure “one version of the truth,” there must be a single originating source for specific data elements, and it is imperative that this source feed the key metrics and targets. The raw data will need to be extracted from the source and transitioned into relevant information available within each metric and target. Depending on the size and complexity of the organization and its systems, it may be a daunting task to determine the true source for data and to ensure its integrity. This, however, is a task that must be accomplished with appropriate due diligence in order to ensure reliable metrics.

Not only should key metrics provide lagging historical views of the organization, but they also should provide leading forward-looking, strategic views of the business climate, competition, regulation and market fluctuations. In many cases, the data required for such metrics does not reside within the organization’s systems, but instead is sourced from third-party systems. With the maturation of standardized service-oriented architectures, this external data is reliably available for consumption and can provide powerful insight into the overall landscape of the business. PRIM² has the depth of scope to include true “what-if” scenarios involving changes and events outside the walls of the organization and their impact on risk management and performance results.

Data Quality and Fidelity – Data quality is one of the most important yet least appreciated components of a robust performance management system. Forty-four percent of companies surveyed by The Data Warehouse Institute believe their data is “worse than everyone thinks.” Two percent of customer master records naturally become obsolete every month due to changes in name, address, e-mail or phone number. Add to this the errors from system upgrades, migrations and user entry, and it is apparent that data quality issues exist within every organization. Therefore, companies should focus on the nine tenets of data quality: accuracy, integrity, consistency, completeness, validity, timeliness, relevancy, accessibility and security. If data errors remain uncorrected, it becomes nearly impossible to monitor and manage performance effectively.

The good news is that data does not need to be perfect: It only needs to meet the requirements for its business function. This means that the data composing the metrics, targets and value drivers needs to be validated in a timely manner to ensure proper tracking and measurement. The precision of data can vary depending on its use – whether it is used in operations, in public reporting or in making strategic decisions. If an investigation determines there are issues with data quality, there are appropriate actions that can be reviewed and implemented based on the cost and need of remediation. These actions are:

- **Identify and analyze it** – Provide reports on the erroneous data, determine its value and assess the business need to correct, delete or ignore it.

- **Correct it** – Update the erroneous data in the source system with correct values or as it is loaded for use in the performance management system.

- **Delete it** – Delete the erroneous data either in the source system or while it is loaded for use in the performance management system.

- **Ignore it** – If the erroneous data does not impact the required metrics or targets, it may be appropriate to ignore it.

- **Prevent it** – Institute new controls, procedures and integrity checks during data entry, migration and processing.

The message is twofold. First, poor-quality data can spawn information for decision-making risk. Second, a robust technology platform is needed to integrate business planning, initiative tracking and performance measurement effectively and provide the necessary transparency into what is really happening in the enterprise.
SUMMARY

Whether a company is rapidly growing, focused on establishing sustainable competitive advantage or both, it must consider how an integrated approach and discipline to deploy strategy while also managing the associated risks will improve the probability of achieving strategic objectives. Risk management can only become a differentiating skill through integration with strategic management and performance management. As depicted in the schematic on the next page, PRIM² is the most effective way we know of to integrate risk and risk management with the governance process and what really matters in the organization’s management processes.

The premise of PRIM² is that many organizations today are facing a volatile and increasingly complex business environment. By effectively communicating and deploying strategy in a consistent manner across the enterprise, proactively identifying and mitigating the risks inherent in the strategy, and ensuring the seamless integration of strategic plans, risk management and performance management in the execution of the strategy, PRIM² provides an integrated approach and discipline to deploy strategy while also managing the associated risks of a changing business environment.

The real-time transparency of PRIM² into the operations of the enterprise to measure current performance and predict future trends facilitates the alignment of the strategy, risk management capabilities and performance management continuously over time. When the strategy is optimized through the consideration of the underlying critical assumptions and inherent risks and its execution is effectively measured and monitored, management and the board of directors will have increased confidence that shareholder value will not only be enhanced, but also protected, consistent with the boundaries of the established risk appetite. This is the balance that the implementation of PRIM² is intended to establish and sustain. As more examples of protection failures continue to surface, it is evident that this balance is vital to sustaining the long-term viability of every organization.
ABOUT PROTIVITI

Protiviti (www.protiviti.com) is a global business consulting and internal audit firm composed of experts specializing in risk, advisory and transaction services. We help solve problems in finance and transactions, operations, technology, litigation, governance, risk, and compliance. Our highly trained, results-oriented professionals provide a unique perspective on a wide range of critical business issues for clients in the Americas, Asia-Pacific, Europe and the Middle East.

Protiviti has more than 60 locations worldwide and is a wholly owned subsidiary of Robert Half International Inc. (NYSE symbol: RHI). Founded in 1948, Robert Half International is a member of the S&P 500 index.

PROTIVITI’S SERVICES

PRIM² is a framework for converging and integrating strategy-setting, performance management and risk management with the objective of positioning the company as an early mover. Protiviti’s services help your organization realize this convergence by delivering deep business insight based on a holistic view of the enterprise. Our Corporate Performance Management (CPM) services address the business challenges facing the corporate finance office and operational decision-makers throughout the organization. Using best-of-breed, state-of-the-art CPM software, our clients have fast and easy access to trusted CPM financial, operational and risk information, enabling a deep understanding of how value is created and protected, and delivering strategic insight so decision-makers can better anticipate future business outcomes and receive better information for decision-making.

We also recognize that risk is an important and vital aspect of managing an enterprise and delivering performance against strategic objectives. Our comprehensive risk management services complement our CPM solutions by helping companies improve their enterprisewide capabilities to identify, source, measure, manage and monitor the critical risks inherent in their corporate strategy and business plans, while incorporating the foundational risk management and controls provided by powerful governance, risk and compliance (GRC) application software tools. The objective is to enhance strategy-setting and performance management with the intent of positioning the enterprise to become an early mover.

For more information about the issues discussed in this white paper and Protiviti’s services, please contact:

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