"Developing Key Risk Indicators to Strengthen Enterprise Risk Management"

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Synopsis by Colin Reinhart

The business world has become more concerned with risk management over the past decade. To motivate this research, the authors noted that in 2004, the New York Stock exchange required their audit committees to report on companies listed on the exchange and their management's risk oversight process. Standard & Poor's began evaluating firm's enterprise risk management (ERM) processes while doing their credit analysis, in 2009 the SEC required disclosures on firm's boards and their role in risk management and in 2010 financial institutions were required to have risk committees within their board of directors.[1] Given the institutional and regulatory interest in ERM, the authors of this study stress the importance that firms use key risk indicators to help signal risks they will face to avoid or mitigate them and ultimately help make their firms more resilient. With the importance of ERM on the rise, this article offers a strategic prescription to firms for more effective risk management.

Key Performance Indicators vs. Key Risk Indicators

Despite the increased focus placed on ERM, firms tend to concentrate on key performance indicators (KPIs) which are mostly *ex post* information sources, based off historical data, which may do little to assess future risks. By contrast, key risk indicators (KRIs) begin with the premise of a future view about risk and metrics are developed by executive leadership as part of a risk management paradigm. An example given by the authors relates to analyzing the collection of accounts receivable. A KPI would look at information about write-offs from the past year to inform management about accounts a firm is struggling to collect. A KRI approach would be more systematic. For instance, management could analyze the financials of their top 25 customers with built in financial alarms which could warn the firm of potential challenges they could face collecting from a certain company. The authors advocate that a KRI should first find the risk event, then look back to intermediate events that lead to it, and finally find the root cause event that generated the ultimate outcome.[2]

How to Effectively Use Key Risk Indicators

To develop a KRI, a firm must first find a current or historical event that has impacted the organization. The firm must then work backwards to find the intermediate and root causes of the event. If a grocery store chain finds a KRI to be that a rise in oil prices causes them to lose customers, the firm can anticipate lower revenues when oil prices are projected to drop. The chain can then take steps in advance to cut costs or mitigate losses before they begin losing revenue. A firm must determine ahead of time what threshold will trigger a certain action. For example, if oil prices drop below $40 the firm will not hire any more employees. Having the action plan in place before an event

[1] Page III

[2] Page 3

will better prepare a company to address a threat or opportunity. The authors table below provides further examples of potential risk events faced by a grocery chain with sample KRIs.

Table 1

Example
Regional grocery store chain seeks to grow earnings by adding new stores in Northern Virginia and Washington, DC area.

Risk Events	Sample KRIs to Monitor Risk Proactively
1. Economic downturn in Washington, DC markets affect retail storefront rental demand and real estate values	• Actual and projected retail store occupancy rates in the Washington, DC market • Commercial real estate rental market information about leasing prices and options for similar quality retail properties in the Washington, DC area.
2. Competition increases in the Washington, DC markets	• Change in number of grocery stores in market area • Announcements of expansions by big-box retailers and superstores • Significant and sustained price reductions by grocery competitors in the Washington, DC area
3. Cost of financing too high	• Spreads on debt issuances for comparably rated companies • Actual and projected interest rates • Company stock performance and related trends in competitor stock
4. Delays in developing property and opening stores	• Compare actual construction and store opening benchmark dates to pre-determined target dates • Monitor construction labor union issues, including competing demands for construction labor that might arise due to other major construction projects in Washington, DC area
5. Long term economic downturn results in deteriorating customer base	• Employment outlook for federal government agencies and government supportive businesses • Forecasts related to unemployment • Consumer spending trends in Washington, DC area

Information Sources for KRIs

It's also important for a firm to consider both potential information sources for KRIs and a methodology for identifying KRIs which will ultimately be judged as high-quality KRIs. The authors set out a reasoned set of core guidelines for KRIs to be effective[3]:

1. Based on established practices or benchmarks
2. Developed consistently across the organization
3. Provide an unambiguous and intuitive view of the highlighted risk
4. Allow for measurable comparisons across time and business units
5. Provide opportunities to assess the performance of risk owners on a timely basis
6. Consume resources efficiently

So, where can firms find KRIs? The authors provide a listing of useful categories which risk managers can use to queue their thought process. First, subject matter experts in different business units can identify root cause events or intermediate events. Second, outside sources such as trade publication and loss registries can be used to identify risks, and third, external sources can also be more objective in reporting risks but face the challenge that they may not be as available as an internal

[3] Page 6

data source. Among this set of information sources the authors express caveats. For instance, business units may be biased toward old metrics and data collection and utilization may have not been standardized in an appropriate fashion. Although internal information is important in identifying historical risks the firm has faced, there may be risks you cannot capture from just internal data.

KRI Communication and Reporting

KRI communication and reporting is a must and the authors assert that the person in charge of overseeing the ERM process should work with the risk owners to develop the KRIs and the action plans. Employees who should benefit most from KRIs are the "risk owners" who as a result should be able to better manage their business units in line with the risk goals of their units. The authors espouse that different roles should review KRI data in different ways; risk owners should review KRI data on risks that impact their unit on a frequent bases, senior management should review KRI data on risks that significantly impact the organization on a less frequent (e.g., monthly) basis, while the board of directors will likely need to review on the KRI data for the most significant impacts on an infrequent (e.g., biannual) basis.[4] Dashboards can be used on reports to display KRI data in an intuitive way with color and directions. In the authors Table 2 an example of a dashboard for a grocery store chain is given:

Table 2

KRI	Status	Trend
Gas prices	🔴	⌄
Change in number of grocery stores in the area	🟡	⌄
Labor union demands	🟢	<>

For a grocery store chain, if gas prices are high and expected to go higher, it would be represented with a red status and downward trend, which signifies the need for the firm to pay close attention to this KRI. If a competing store is being built near the chain's stores with more planned, but didn't represent major threat at the moment, that KRI could be represented with a yellow status and downward trend. Next, it's easy to see that there are no new labor union demands and that there aren't any likely in the future. This dashboard quickly and clearly communicates to management what they need to be concerned with and where to focus their attention in order to keep the chain successful.

Conclusion

Properly developing KRIs that are effectively communicated throughout the firm will help identify the company's risk appetite will make a firm more responsive and proactive to risk events, they will help management identify trends in risks they face, effective KRIs will help firms show their compliance with risk management and lower the involvement from regulators, and finally they will improve a company's performance through less stressful work environment that won't frequently be in crisis mode.

[4] Page 8