10-29-2014

The Role of Finance and Accounting in Enterprise Risk Management

Christopher D. Ittner

How does access to this work benefit you? Let us know!
Follow this and additional works at: https://academicworks.cuny.edu/bb_pubs

Recommended Citation
https://academicworks.cuny.edu/bb_pubs/1014

This Presentation is brought to you for free and open access by the Baruch College at CUNY Academic Works. It has been accepted for inclusion in Publications and Research by an authorized administrator of CUNY Academic Works. For more information, please contact AcademicWorks@cuny.edu.
THE ROLE OF FINANCE AND ACCOUNTING IN ENTERPRISE RISK MANAGEMENT

Let me begin by thanking Baruch College for giving me the opportunity to present this year’s prestigious Emanuel Saxe Lecture in Accounting. I am especially excited to be speaking about a topic that I believe will have a significant impact on the accounting profession – the implementation of integrated enterprise risk management (ERM) processes. In tonight’s talk, I will discuss the current role of the finance and accounting organization in risk management, and my views on how these roles can be extended to allow finance and accounting to help organizations more effectively manage, monitor, and potentially exploit risk situations to enhance performance.

What is Enterprise Risk Management?

Recent financial crises, regulatory changes, security breaches, and natural disasters have prompted regulators, accounting organizations, credit raters, and others to call for greater emphasis on risk management activities. Firms are being pushed to move beyond traditional risk management practices that operate within functional silos to embrace more holistic enterprise risk management. ERM represents an integrated, firm-wide process and control system for identifying and prioritizing critical financial, operational, strategic, compliance, and other risks facing the organization, assessing their impact on financial and strategic objectives, and implementing organizational solutions to address them. [1]

ERM requires the development and implementation of a holistic, cross-functional framework that establishes and communicates the firm’s risk management philosophy and risk appetite, and provides the tools and processes for identifying internal and external events that affect the achievement of an entity’s objectives; assessing the likelihood and impact of different
risks; selecting risk responses (i.e., risk avoidance, reduction, sharing, or acceptance) to align risks with the entity’s risk tolerances and risk appetite; implementing control activities to help ensure the risk responses are effectively carried out; identifying and reporting information in a form and timeframe that enable people to carry out their responsibilities; and ensuring the entirety of enterprise risk management is monitored and modifications are made as necessary.

The big question is whether any of these practices actually make a difference in terms of risk reduction or organizational performance, or are simply knee-jerk reactions to the large number of highly-visible and damaging risk failures in recent years. A growing body of research suggests that the latter is not the case. Organizations with more mature ERM processes tend to have fewer major risk events with smaller effects, lower cash flow, earnings, and stock price volatility, and higher accounting and stock returns. These potential benefits, together with external pressure from regulators, investors, and credit rating agencies, are pushing more and more organizations in both the public and private sectors to implement ERM processes. In my view, the accounting profession can and should play a leading role in this movement.

**The Current Role of Finance and Accounting in Risk Management**

Now some of you may be asking, don’t finance and accounting organizations (which I will subsequently refer to simply as finance) already do this? To some extent you are right. Finance has traditionally been involved in the management of financial risks through the use of derivatives, insurance, and other financial instruments. The passage of Sarbanes-Oxley has further expanded finance’s risk management role to encompass internal control and compliance activities. Regulatory changes have also prompted greater integration of finance’s various risk-related activities. Historically, treasury has focused on interest rate, credit, liquidity, and other financial risks; the compliance function has monitored risks such as noncompliance with
applicable laws and regulations; risk management has facilitated and monitored the implementation of effective risk management practices by operational managers; and internal audit has provided assurance on the effectiveness of governance, risk management, and internal controls. These distinct activities are now merging. The introduction of Sarbanes-Oxley, together with currency transaction and corruption regulations, have increased the need for treasury to perform compliance and internal control activities. Internal audit is using its knowledge of the organization’s financial risks and familiarity with risk-based assessments to take on risk management activities such as facilitating the identification and evaluation of key risks, developing risk management processes, and generating risk reports. Risk management is increasingly providing input into internal audit’s assurance process.

Given the role finance has traditionally played in risk management, it is not entirely surprising that CFOs are considered the primary “risk owners” in the majority of organizations. Some argue that this risk ownership responsibility is appropriate due to finance’s existing expertise in risk management, the importance of internal controls and regulatory reporting compliance, and the CFO’s expansive financial perspective, which is needed to holistically monitor the economic impact of risk and manage the risk-based planning and resource allocation process. But this view is not universal. A growing number of ERM advocates argue that placing primary responsibility for risk management in the hands of the CFO biases the risk management process towards financial risks, leads to conflicts of interest between the finance’s dual roles in both managing and monitoring risk-taking, and hinders the adoption of holistic risk management practices by fostering disagreements between the priorities of the CFO and the priorities of other functions. Instead, these advocates call for risk ownership to be transferred from CFOs to newly-created Chief Risk Officer positions, a troubling movement for the accounting profession.
How Can Finance Increase its Contribution to ERM?

To maintain and enhance its position as the primary owner of the organization’s risk management activities, I believe that finance will need to move beyond its traditional focus on financial and compliance risks to take a broader, more holistic view of enterprise risks. The existing biases in finance's risk responsibilities are seen in the figure below, which shows the extent to which finance contributes to managing various types of risks. Not surprisingly, finance’s greatest contributions relate to traditional compliance, credit, and liquidity risks. Finance’s contributions to other operational and strategic risks, on the other hand, are far less extensive. Finance is least involved in managing catastrophic and financial fraud risks, the latter result reflecting the separation of duties for managing financial activities from responsibility for detecting and reducing fraud in these activities. Finance's contributions to managing other types of strategic and operational risks are partial at best.

Greater focus on non-traditional operational and strategic risks will require finance to become more cross-functional. Cross-functional risk management is claimed to be one of the primary features distinguishing ERM from traditional silo-based risk management. Yet surveys indicate that fewer than half of finance organization make key contributions to cross-functional risk management, with most finance organizations' risk-related activities remaining functionally siloed. This is a major limitation, especially since CFOs whose organizations are key cross-functional contributors report greater finance department effectiveness not only in enterprise risk management activities, but also in traditional statutory compliance and performance management activities, highlighting the potential synergies between these various activities.
One specific area where finance is well-equipped to increase its contribution to more holistic ERM is adopting risk-based forecasting and planning practices. Clearly, forecasting and planning are fundamental to finance’s monitoring and decision support roles. And most firms make some attempt to take risk into consideration when forecasting and planning. However, these efforts are often undertaken on an informal, qualitative basis with little interaction between financial planning, strategic planning, and risk management. Survey research conducted by the professional services firm Aon in collaboration with Wharton finds that more than a third of publicly-listed US companies rarely or never explicitly reference risk assessments or analysis plans in their budgeting process. Fewer than thirty percent explicitly incorporate different risk-
based return expectations for different business units and functions in budget and resource allocation decisions, and less than a quarter formally apply risk appetite and/or tolerance concepts to strategy development, or formally incorporate key risk information from the risk management process in the strategic planning process.

Risk-based forecasting and planning (or RBFP) provides a mechanism for improving the incorporation of risk considerations into integrated forecasting and planning processes. Key elements of RBFP include explicitly defining the firm’s risk appetite (the amount of risk exposure the firm is willing to accept to achieve its objectives), risk capacity (the maximum level of risk the firm can assume given its current level of financial and nonfinancial resources), and risk tolerances (the acceptable variation in outcomes related to each relevant risk); employing more sophisticated quantitative and qualitative methods to evaluate and monitor the key risks, risk drivers, and risk interdependencies facing the organization; and formally incorporating this information across the firm’s financial and strategic planning processes. Potential benefits from these practices include allowing organizations to better manage and reduce cash flow, price volatility through risk avoidance, mitigation, sharing, and contingency planning efforts, and enhancing forecasting ability itself through the use of more sophisticated forecasting methods, improved alignment of financial and strategic actions, and greater consensus regarding the firm’s willingness and capacity to take risks. Consistent with these potential benefits, research indicates that firms with more sophisticated risk-based forecasting and planning practices are better able to adjust strategic actions in response to new information on emerging risks, have smaller earnings forecast errors, and experience lower volatility.

Better integration of “key risk indictors” into the organization’s strategic performance measurement systems provides another opportunity for finance to exploit its comparative
advantage in support of ERM efforts. Risk management cannot become part of the strategic agenda if it is treated as something distinct from the organization’s ongoing performance measurement and management practices. But fewer than half of firms report that routine management monitoring and reporting (for example, heat maps, dashboards, or scorecards) include risk factors. Of these, less than 40 percent consistently identify and track risk metrics for key risks, and nearly a quarter rarely or never do so. And even when key risk indicators are tracked, less than a quarter of organizations incorporate these indicators in their regular performance measurement system, instead tracking them separately.

Potentially more problematic is the lack of thresholds or targets for many of these metrics. It is not clear how you assess how you are doing on a performance metric without a target. Yet fewer than 30 percent of organizations consistently set quantitative thresholds and tolerances for key risks and nearly 30 percent never do so. As the old saying goes, you get what you measure. If risk metrics do not become part of the strategic measurement portfolio, ERM is unlikely to become an integral part of the organization’s activities. As the organization’s primary scorekeeper, finance is in a unique position to make this happen.

**How Will This Affect Finance’s Other Responsibilities?**

One concern with expanding finance’s risk management responsibilities is that it will adversely affect finance’s many other tasks. There are only so many resources to go around, and increasing the demands for one activity can reduce the time available for another. Although a valid concern, CFOs do not perceive tradeoffs between the adoption of ERM practices and finance’s effectiveness in non-ERM activities. Rather, the enterprise-wide use of many ERM practices is associated with greater perceived finance department effectiveness not only in supporting, managing, and mitigating enterprise risk, but also in meeting fiduciary and statutory
requirements, leading finance-related compliance programs and strengthening internal controls, and measuring and monitoring business performance. These relationships are shown in the table below. The enterprise-wide establishment of risk thresholds, for example, is positively associated with finance’s perceived effectiveness in fiduciary/statutory, ERM, and performance measurement activities; both risk-based forecasting and planning and integrated risk and performance measurement systems with finance-related compliance and internal control, ERM, and performance measurement; and embedded process controls (which prevent many risks from occurring in the first place) with the effectiveness of all four of the finance activities. In no case is an ERM practice associated with lower perceived effectiveness. If there are doubts regarding the value of ERM practices to finance organizations, the responses from CFOs participating in this survey begin to dispel them.

<table>
<thead>
<tr>
<th>ERM PRACTICES AND PERCEIVED FINANCE EFFECTIVENESS</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td><strong>Fiduciary/Statutory</strong></td>
</tr>
<tr>
<td>------------------------------------------------</td>
</tr>
<tr>
<td>Formal Risk Identification</td>
</tr>
<tr>
<td>Routine Risk Monitoring</td>
</tr>
<tr>
<td>Historical Comparisons/Variances</td>
</tr>
<tr>
<td>Risk Thresholds</td>
</tr>
<tr>
<td>Risk Forecasting/Planning</td>
</tr>
<tr>
<td>Embedded Process Controls</td>
</tr>
<tr>
<td>Economic Capital Allocation</td>
</tr>
<tr>
<td>Integrated Performance Measurement</td>
</tr>
</tbody>
</table>

+ = Statistically significant positive effect on perceived finance effectiveness on that dimension.
Conclusions

Finance and accounting professionals (and academics) are in a unique position to play a leading role in ERM initiatives. This will require going beyond traditional compliance and risk mitigation activities to support broader performance management efforts. Areas where finance is in a particularly strong position to increase its contribution to ERM are in the development and analysis of key risk indicators, the financial quantification of risks, and the integration of ERM into traditional finance and accounting areas such as investment decisions, budgeting, financial reporting, and compensation and incentives.

But now is the time to move. The rise of Chief Risk Officers is threatening to remove many risk management responsibilities from CFOs. Similarly, the growing importance of information technology to internal control, data security, and other compliance issues has fostered greater Chief Risk Officer involvement in risk management efforts and created potential conflicts between the CIO and CFO over the ownership of compliance risks. In fact, some surveys indicate that CIOs are expected to replace CFOs as the primary risk owners in many organizations. Given finance and accounting organizations' expertise in many of the risk management and control system attributes that are key components of ERM processes, greater rather than reduced involvement by finance and accounting in risk management seems warranted. However, this will require finance and accounting organizations to adapt their efforts to the new world of more integrated and holistic risk management if they are to avoid being passed by in the push for ERM.

Notes

for details on the ERM process. Data discussed in this lecture are drawn from surveys conducted by Aon or IBM in collaboration with researchers from Wharton.