White Paper: Integration of Balanced Scorecards with Enterprise Risk Management

Executive Summary

In this White Paper, we outline **how Veridian Connections Inc. has integrated Balanced Score Cards with their Enterprise Risk Management program.** This whitepaper has been authored in partnership with Laurie McLorg from Veridian Connections Inc., a progressive North American utility.

Since the early 90's, Balance Score Card (BSC) has been used by thousands of successful companies, both big and small, to help align the strategies and activities undertaken by a company with their overall corporate objectives and provide a summary to senior management to increase the transparency of reporting. BSC is widely recognized to provide substantial benefits to senior management and stakeholders of organizations both large and small.

The concept of identifying, assessing and managing the risks of an organization, known as Enterprise Risk Management (ERM), has also been used by successful companies to increase the chance of achieving a company's objectives. The Deepwater Horizon oil rig explosion in the Gulf of Mexico that so negatively impacted BP, Haliburton and Transocean is an example of a risk that was not planned for sufficiently. An appropriate Action Plan could have drastically reduced the environmental, financial and reputational damage done to these companies.

"A formal risk assessment might have enabled the BP Macondo well team to identify further mitigation options to address risks such as the possibility of channelling; this may have included the running of a cement evaluation log." [i]

Both management tools are well-recognized and accepted among academicians and more importantly business leaders. They link the high level corporate strategies as determined by the senior leadership team with the day-to-day activities of the employees within the organization. Until now, there has been limited interconnectivity; yet at a fundamental level, they seek the same goal – help the organization achieve its corporate objectives. The integration of these two management tools is a natural step in the evolution of corporate management. We will attempt to illuminate a number of the benefits in this White Paper.

We use a simple technology tool to illustrate how the integration could work and then describe a real-life case study at Veridian that has succeeded in integrating their BSC and ERM programs within the technology solution described.

The resulting integration results in a reduction of time spent on these two important management areas, a more comprehensive picture of the activities a company is doing to achieve its objectives, individual scorecards for all levels of management from senior members to front-line managers and a reporting tool that combines all the information so that management can make more informed decisions.

What is a Balanced Scorecard?

Mobil Oil (now Exxon Mobil) leaped from last to first in profitability within its industry from 1993 to 1995, a rank it maintained for the next four years. Cigna Insurance was losing $1 million a day in 1993, but within two years it was in the top quartile of profitability in its industry. Then in 1998 it spun off a $3.5 billion division. What's the key to these dramatic turnarounds? These companies attribute at least part of the solution to having implemented the Balanced Scorecard. [ii]

The Balanced Scorecard (BSC) concepts were introduced in a research paper published by Harvard University Professors Drs. Kaplan & Norton in 1992; this popular paper was followed by a second in 1993. In 1996, they published the book *The Balanced Scorecard*. BSC is considered by many people to be one of the most influential management ideas of the past 75 years. It has consistently ranked among the top management tools according to Bain's annual survey of Management Tools. [iii]

Growth and revenue generation are most organizations' prime objectives. Traditionally organizations' leaders focused exclusively on the Financial Perspective. However, to achieve long lasting, sustainable success an organization needs to focus on other perspectives too; such as the Customer Perspective, the Internal Process Perspective and the Learning and Growth Perspective. The balance of focus on more than just the Financial Perspective is the philosophy behind a successful Balanced Scorecard.

BSC is a strategic management system that helps organization translates its strategies into objectives that drive both behaviour and performance. Both financial and non-financial Measures are designed to track the progress of Objectives against targets.

- BSC illustrates an organization's strategy in terms that all members of an organization can understand.

- Objectives drive performance. They are action statements that create measurable results indicating the success level of executing the strategy.

Because the Balanced Scorecard requires every action to answer to established corporate goals, using the Scorecard within IT can still help promote alignment and eliminate projects that contribute little or no strategic value. "It really changes the conversation between IT and business," says Linda Bankston, CIO of DuPont Engineering Polymers, a $2.5 billion division of DuPont Chemicals in Wilmington, Del. "The conversation is around strategy and impact, rather than just whether you can or can't do something." [iv]

BSC assists in the alignment of strategy and operational objectives. When a business unit implements BSC, it is able to clarify priorities, quickly and clearly communicate its objectives, and align its activities with those of the enterprise and similar business units. The underlying philosophy of BSC is to seek balance between achieving short and long-term strategic objectives.

A 1997 research found that 64 percent of the companies questioned were measuring performance from a number of perspectives but without the consolidated view that a Balance Scorecard provides.

Balanced Scorecards have been implemented by government agencies, military units, business units and corporations as a whole, non-profit organisations, and schools.

The recent financial crisis revealed a gap in management focus. Companies were focused on shareholders' value, revenue growth, productivity, cost control and quality without explicitly incorporating risk management as part of their strategy execution exercise. In a recent HRB Article, v BSC creators acknowledged that the measurement, mitigation and management of risk has not been featured in their work in the past and the recent economic meltdown has prompted them to think more deeply about incorporating risk management into strategy execution framework.

What is Enterprise Risk Management (ERM)?

In the 1990's, a large automotive company ("the Company") recognized an exposure to price fluctuations in the rare metal palladium, an important component in catalytic converters. Two actions were taken:

- The purchasing department hedged the exposure by signing long-term contracts to purchase palladium at stable prices.
- The Company's Research & Development department recognized the same risk, and redesigned catalytic converters requiring minimal palladium.
- The result was that in 2001, when the price of palladium dropped from $1,500 to $400, the Company suffered a loss of $1 billion. The problem was that the Company had a decentralized risk management program that didn't have one person overseeing the Action Plans being taken by different groups.

Enterprise risk management (ERM) includes the methods and processes used by organizations to manage risks and seize opportunities related to the achievement of their objectives. A properly designed Risk Management program will help an organization align their activities with their strategies and objectives. It will provide well thought out and performance tested action plans, which can be instituted should a negative risk event occur. (e.g. physical oil retention strategies, PR communications to stakeholders and activation of disaster recovery plans in the oil rig disaster.) It will consider actions that can be taken to minimise the impact of a negative event, should it occur (e.g. blowout preventer and backup relief wells to be prepared ahead of time to be used if necessary thereby minimizing the environmental impact.)

If the Company had had a centralized risk management process with a risk repository database system in place, the contradictory Action Plans would have been identified because they would both have been mitigating the same risk and seen in an Action Plan report and dealt with.

The benefits to implementing a robust Risk Management program include

- Increase the likelihood of achieving objectives
- Improve the identification of opportunities and threats
- Improve governance
- Improve loss prevention and incident management
- Improve organization learning and resilience
- Improve the ease of implementation

One of the more recent trends in ERM has been to ask participants identify risks that impact their objectives, rather than identify risks that exist. They no longer need to ask "the risk to what?" When risks are NOT tied to your business objectives it is like asking people to navigate an *uncharted* minefield.

- It is an avoidance strategy – stay as far away from the mines (risks) as possible.
- If someone steps on one (risk event) everyone scatters.
- The team's focus is down on the ground, not on the other side of the field (objective).

Another trend in Risk Management specifically addressed in ISO 31000 is to state that risk events are neutral; they can have a positive or negative impact on the organization's objectives. This allows the risk practitioner to more perceived value from the program because they are helping the Line Manager participant to look for more ways to meet their objectives (and hopefully obtain their bonus.)

Numerous frameworks have been created and applied to business over the past two decades. ANZ 4360 was an early version developed in Australia and New Zealand. COSO ERM was a more granular version developed in the United States. Recently, the need for an updated international version was recognized and representatives from many countries around the world convened to develop a new standard under the ISO banner. ISO 31000 – Risk Management is the newest and most comprehensive standard to date. It combines the traditional fundamentals of ERM with the learning's from implementations of COSO ERM and ANZ 4360.

ERM's Re-Emergence

In the year 2000, Risk Management and the need for a comprehensive program was increasing in importance for many forward-thinking companies. When the US released SOX, ERM took a back-seat, as companies were forced to spend large sums of money and time designing and testing internal controls over financial reporting. The result was an excessive focus on the business process level financial controls of the organization that ensured the completeness, existence and accuracy of the Financial Statements. The controls were completely focused on the financial reporting risks of the company without any consideration of the operational, strategic, HR or other enterprise risks that a company may face. It wasn't just ERM that suffered but the efforts of entire Internal Audit departments of companies were directed towards ensuring the design and operating effectiveness of financial reporting controls was appropriate, leaving little time or money for operational risk consideration.

The global economic crisis re-awakened the recognition that a comprehensive risk management strategy needs to be focused on more than just the Financial Statements and the associated reporting risks. Many commentators have pointed towards the lack of consideration of risk as a direct driver of the recession. [vi]

"The prevailing view, as far as the public, their elected representatives and our regulators are concerned, is that the fire itself was the product of a shocking and fundamental failure of risk management and oversight in the markets we serve." [vii]

ISO 31000 has refocused the ERM approach from being a checklist of risks that a company addresses to a value-added program that helps a company achieve its objectives. This value-add component has meant that senior management figures are more likely to pay attention to the program. The focus of ERM on objectives provides a natural link to the Balance Scorecard approach as we will discuss in the next section.

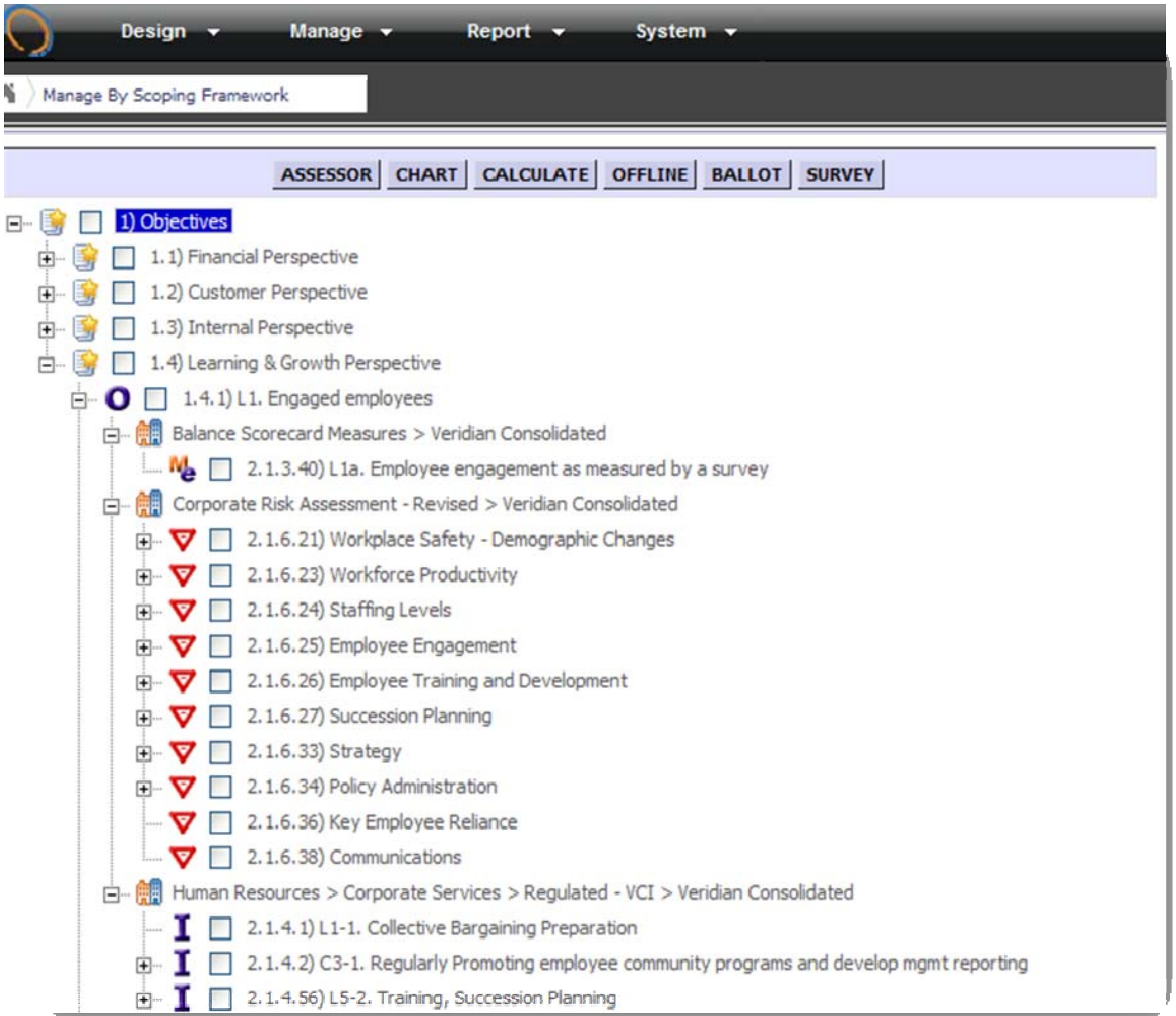
BSC & ERM's roles as management tools

As mentioned already, until recently the activities leading to the development of Strategy and Risk Management were conducted independently. Usually an organization's Senior Leadership Team (SLT) develops the strategic plan. Risk Management is considered an activity to be conducted by Risk professionals. Due to the segregation of Strategy and Risk Management the SLT failed to instil sound measurement, mitigation and management of risk practices in their strategic plan. An analysis of the recent failure of many companies reveals that the SLT failed to acknowledge and manage excessive risk which was inherent in the companies' pursuit of short-term financial gain over long term stakeholder value.

An often repeated statement from line managers is that “we deal with risk every day, that’s what I’m here to prevent.” This is a short-sighted answer. What if they are incapacitated, who would ensure the risks were dealt with appropriately? Risk Management encourages the documentation of risks and the resulting Action Plans. It is about making management scientific rather than intuitive.

Although the management of strategy and risk practices have been conducted separately in the past, we contend that it is more effective to integrate these activates. BSC produces a list of objectives and corresponding initiatives and tasks to achieve those objectives. ERM asks what risk events may occur that will impact the achievement of the objectives as identified in the BSC. Therefore, by creating a Balanced Scorecard, a company is setting up the necessary components to complete a highly effective ERM process.

The picture on the next page illustrates an example of an integrated framework in BPS Resolver’s GRC Cloud. It shows the Objectives ( ), with the Measures ( ), the Risk Areas, ( ) and the Initiatives ( ) linked directly underneath. The Risks lie within the Risk Areas.



LEGEND: O Objective Me Measure Risk Area I Initiative

Picture 1: Example of an integrated framework from the Veridian Case Study to follow.

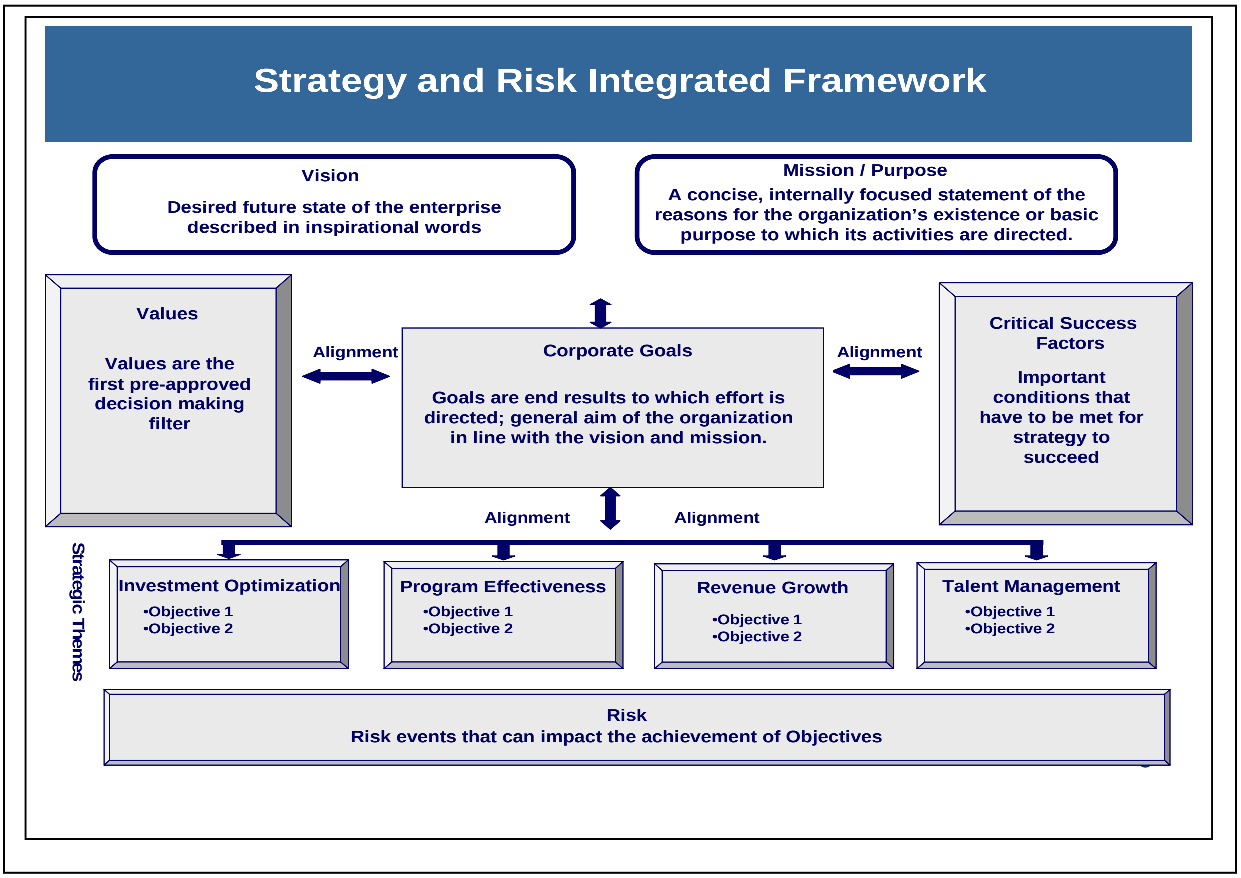
Benefits of Integration

The most modern ERM practices say that risks are events that impact the achievement of your objectives. Since BSC is the driver of your objectives, there is a natural link between the BSC and ERM programs at a company.

To illustrate how this could be used consider the following process:

1. Develop the objectives of the organization and the strategies required to achieve those objectives.
2. Allocate responsibility for each of those objectives to the appropriate personnel within the organization, Objective Owners.
3. Metrics are determined for each objective so that the progress of that objective can be tracked.
4. The Risk Manager facilitates workshops with each of the Objective Owners and the people they deem appropriate to bring the workshop. At the workshop, the Risk Manager asks the question, what events could occur in the next 18 months that would impact the achievement of your objectives.
5. The Objective Owner then assigns those risks to Risk Owners to select Treatment Plans and develop comprehensive Action Plans as appropriate.
6. Metrics are determined for each Risk so that the occurrence of the Risk event can be anticipated to the greatest extent possible.
7. The Objective Metrics and the Risk Metrics are tracked to provide Senior Management with a perspective on the chance of achievement of the Objectives.
    a. Financial Resources can be allocated between the objectives and risks as appropriate to maximise the chance of achievement of the Objectives.
    b. Strategies can be tweaked and changed as time passes and situations change.

Picture 2: Example of an Integrated Framework



At the end of many risk assessments, I hear the comment, “What do we do with this list of risks now?” When the risks are integrated with a company's strategy, this question become moot because business owner will deal with the risks to achieve their objectives. Integrating Risk Management into your Balanced Scorecard can help an organization to “stretch” to achieve its objectives.

Veridian Case Study

Veridian Connections Inc is an electricity distribution utility servicing 110,000+ customers across various service areas in Southern Ontario. In 2008, Veridian engaged in their strategic planning activities – which included the development of a Balanced Scorecard, including high level objectives and company-wide initiatives designed to achieve those objectives.

Veridian turned to BPS Resolver and the GRC Cloud solution to hold the information created in the Balanced Scorecard process, to track the information and provide dashboards and reports to help management understand how their business was progressing.

These initiatives were assigned to management staff - “Initiative Owners” across organization. In the process, Veridian realized that an important component of risk management was missing – while they had been “managing risk” for years on an ad-hoc basis, no formal framework was in place.

In 2009, an independent risk management program was put in place through company-wide risk identification and assessment processes. Management staff was assigned Key Risk Areas assigned becoming “Risk Owners”.

In 2010, the company realized that these two areas are intricately linked. Veridian called BPS Resolver and CLCI and together, the organizations built a Balanced Scorecard with integrated Risk Areas. The risks can be assessed on a periodic basis within the application. Reports can be created that show the information in a multitude of fashions.

“The integrated framework of BSC and ERM brought everything together for us. We use it as a ‘lens’ for strategic business decisions as it keeps risks in the ‘viewfinder’ so to speak, when we’re developing initiatives to meet our key business objectives. This view extends to every level of management as they are owners of both risks and initiatives for their piece of the strategic plan. Having everything in a single reporting software makes it a very ‘usable’ solution for our busy management team. At a high level it provides an overall view of the status of our risk treatment plans and of our progress on initiatives. This serves as a great dashboard or snapshot for both our Executive and our Board of Directors.”

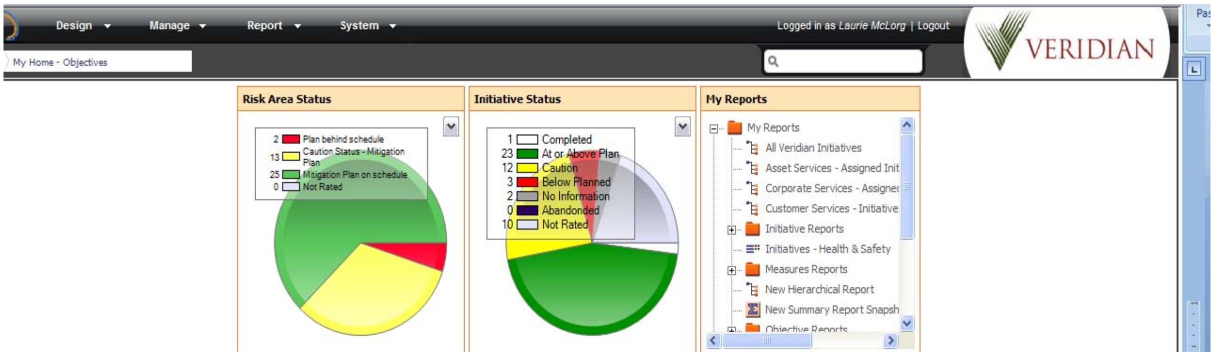
Testimonial from Laurie McLorg - Manager, Corporate Planning – Veridian Connections Inc.

Picture 3: Status Report on Objectives, Initiatives and Key Risk Areas

Status Report on Objectives, Initiatives and Key Risk Areas

Objective	Initiative	Status	Initiative Owner	Risk Area	Status	Risk Owner
Engaged employees	Collective Bargaining Preparation		HR Manager			
	Regularly Promoting employee community programs and develop mgmt reporting		HR Manager			
	Training, Succession Planning		HR Manager			
				Workplace Safety - Demographic Changes		Safety Officer
				Workforce Productivity		Operations Manager
				Key Employee Reliance		HR Manager
				Communications		Communications Officer

Picture 4: Dashboard



Conclusion

In this White Paper, we described how BSC and ERM have evolved, changed and re-emerged over the past 20 years. Organizations achieve their vision by carefully planning and meticulously executing their strategic plans. By linking the day to day activities of the business to the corporate objectives, there is a greater chance of successfully staying on track.

We talked about BSC and ERM's utility as management tools that both help organizations achieve their objectives. From this realization, we explained how a company can benefit from integrating their ERM and BSC programs.

Finally, we discussed the recent industry trend of BSC and ERM integration by sharing a success story of this fusion at Veridian along with a snapshot of the technology that Veridian used, BPS Resolver's GRC Cloud, to make this integration sustainable.

The authors are experienced at both BSC and ERM integration and have proven success at integrating the two areas. Hopefully, your organization can attain the same benefits of integration and help your company achieve its objectives.

End Note References

[i] Deepwater **Horizon** Accident Investigation Report Page 36;
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[v] *Balanced Scorecard Report: November- December 2009 – Vol. 11, N 6 – Harvard Business Publishing*

[vi] *Balanced Scorecard Report: November- December 2009 – Vol. 11, N 6 – Harvard Business Publishing*

[vii] Remarks by Donald F. Donahue, Chairman and CEO, The Depository Trust & Clearing Corporation, Annual DTCC Executive Forum, September 27, 2010, New York, Collaboration, Innovation and Leadership