Perspectives on Integrated Business Risk Management (BRM) and the Implications for Corporate Governance

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There is increasing interest by top management in matters connected to integrated Business Risk Management (BRM). At the same time, BRM frameworks aimed at facilitating compliance with corporate governance requirements are being developed (e.g. Lipworth, 1997). This paper explores ways in which top managers in six UK companies covering the service to manufacturing sectors and ranging in size from large to small took practical steps towards understanding and implementing BRM. Approaches by managers ranged from the naïve to the sophisticated. In the study one of the particular perspectives considered was the possible influence of legal considerations. In this context, one of the principal drivers to introducing BRM in the present climate of corporate accountability was found to be fear of exposure in the media for mis-handling risks rather than concerns about the enforcement of any law.

Introduction

Directors and Boards are being challenged to show that they exercise power properly over their respective corporate entities. Concerns in this area in the UK have generated a series of committees charged with deliberating about what should be done particularly in the case of listed companies (Cadbury (1992), Greenbury (1995) and Hampel (1998)) and have highlighted problems in corporate governance. These deliberations have culminated more recently in draft guidance from the Turnbull Working Party (1999). One of the key features running through reports from these committees is for directors to demonstrate adequately that they have properly handled business risks, impacting upon entities for which they have responsibility and for which they are accountable. In particular, guidelines were set out in the Cadbury Report, the essence of which is that directors should have firm control, supported by clear internal controls and effectively know what is going on.

The legal framework, which forms the backdrop for corporate governance, is fairly well developed by the Companies Acts 1985 and 1989 and the common law. Additional layers have in recent years been added to this in the form of codes of practice arising from the aforementioned corporate governance committee reports. Through these a 'best practice culture' has, at least in theory, grown up and is widely reported in the media (e.g. Mount 1999). This raises questions as to the extent of the diffusion of this 'best practice culture' and whether directors in general, in practice, conduct themselves with these requirements and guidelines to the fore of their day-to-day decision making.

Business Risk Management (BRM)

The literature on understanding and handling

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risk is longstanding, extensive and applies to a whole range of settings. In recent years there has been a move to pulling together different elements of risk into common frameworks. An early example was in project management where the impact of risk on the key planning and control parameters of time, cost and specification are critical (Williams, 1995). This process orientated perspective has now been extended to the business overall through means of what are called integrated Business Risk Management frameworks. These frameworks do have their critics:

> ... I find the Arthur Andersen checklist approach to be somewhat banal. (Whittington in ICAEW, 1999)

The more recent roots of these integrated BRM frameworks, which are now enthusiastically referred to by many practitioners (Nottingham, 1996), can be traced to earlier work by academics. Academics attempted to understand how managers could handle different risks at the same time, for example, in international environments, of financial and non-financial kinds, operationally and strategically (Miller 1992). One of the key outputs from this work was the ability to see how the risk trade-offs related to alternative possible business strategies could be handled.

Concurrent with the work being put in to develop integrated BRM frameworks has been the academic work undertaken to better understand managerial perspectives on risk taking and behavioural factors that come into play. An early seminal study was undertaken by March and Shapira (1987). Importantly they observed:

> Managers are quite insensitive to estimates of the probabilities of possible outcomes; their decisions are particularly affected by the way their attention is focused on critical performance targets ....

The March and Shapira study essentially highlighted the care that is needed in developing theoretical and rational approaches to BRM, often based around checklists, and for more understanding of the behavioural factors that managers bring with them in arriving at decisions and taking action. However, it has been argued (ICAEW 1999) that at least checklists establish a starting point for managers to work from to launch BRM initiatives.

This paper reports on a study aimed at understanding how top managers in a small sample of UK based businesses perceived their particular business risks individually and collectively and what steps they took, if any, to assess their impact on the business and how they treated the risk(s). In our discussions and observations of findings, we particularly considered what some of the legal considerations might be for top managers as a consequence of how they handled risks, or not, in their respective businesses. The study took into account the fact that top management operates under intense time pressures and the ever increasing need to improve business performance and create ever higher levels of value for shareholders.

Theory and Practice of Business Risk Management

Theoretical definitions of risk are very difficult to achieve. March and Shapira (1987) state that:

> ''Finding a satisfactory definition of risk ... has proven difficult'' and observe that ''individuals ... are more comfortable with verbal characterisations of risk than with numerical characterisations ... and the ways in which human decision makers define risk may differ significantly from the definitions of risk in the theoretical literature, and that different individuals will see the same risk situation in quite different ways''.

Arguably, this is partly because by its very nature, the exercise of constructing a definition, which provides a focus for a concept, invariably is to narrow, perhaps dangerously, what in reality must remain a very wide and increasing area of relevant issues. Sitkin and Pablo (1992) have also attempted a definition of risk, clearly mindful of the dangers of narrowing the definition:

> Risk is ''the extent to which there is uncertainty about whether potentially significant and/or disappointing outcomes of decisions will be realised''.

This definition fails to provide a useful tool for BRM in practice, because in fact it does not focus sufficiently on issues which can be taken on board by managers to be used in the creation of a BRM strategy. It barely creates a focus for academic discussion of risk. Managers can hardly be expected to adopt such a definition.

BRM has been extensively considered from a qualitative perspective; see for example Williams 1995, Adams and Martin, 1982). However, academic research by March and Shapira 1987 referred to earlier and by Helliar et al, 1998 has suggested that managers adopt a more qualitative rather than quantitative approach to BRM. It has also been observed that in practice, managers tend to look at the negative side of risk distributions rather than the whole range and that where they do not fully understand risks, they tend to merely deny the existence of risk (March and Shapira 1987).

Extensive international surveys have been used by consultants, together wit their own expertise, to develop practice models for BRM, which can be used in a range of business settings (see for example, Arthur Andersen and EIU, 1995, the ''Andersen Model''). These models tend to link strategic and environmental considerations seemlessly to internal and operational factors in a way that is consistent with contemporary views of organisations as 'boundaryless'. Particular issues which are taken into account, include legal and regulatory risks and financial risks, especially shareholder relations and capital availability.

Prudent directors seek advice from experts with a view to putting in place adequate BRM systems Lipworth (1997). Such advice may entail top management being urged to adopt models as a means of focusing their attention on the issues which need to be addressed. Indeed advice can go so far as to imply that if accepted models are used, a BRM system will emerge, which will keep top management safe from criticism. The truth is, however, that modern corporate governance principles required a good BRM system not only to be put in place, but to be monitored regularly (ICAEW, 1999). Simply ticking boxes is not the answer to this.

As the Committee on Corporate Governance (Hampel Committee Report 1998) stated at 1.14 –

> box ticking ... can be seized on as the easier option that the diligent pursuit of corporate governance objectives. It would then not be difficult for lazy or unscrupulous directors to arrange matters so that the letter of every governance rule was compiled with, but not the substance. It might even be possible for the next disaster to emerge in a company, with on paper a 100% record of compliance.

Hampel went on to say:

> The true safeguard for good corporate governance lies in the application of informed or independent judgement by experienced and qualified individuals – executive and non-executive directors, shareholders and auditors.

In practice the environment of heightened awareness of the importance of being seen to handle BRM properly and report on it, has given rise to a series of narrowing prescriptions put forward in models to be used by those who, either do not fully understand all the implications, or who do not have the time to explore them. If these become standards, or codes there is a danger that they will 'straight-jacket' more knowing and thinking managers into making presentations or representations that are inappropriate and possibly irrelevant to their particular entities. Arguably to act in this way is to encourage the provision of improved documentation of business risks and their handling, but the question remains as to the appropriateness of this approach and in particular the impact, which documented information may have, showing action taken on BRM by top management if things go wrong and legal action is taken. It may indeed provide the necessary proof that management has not achieved the standards required in managing the business.

Outside of legal action being taken, organisations and their top management may not be protected from accountability in the 'Blame Culture' that now exists in the UK (e.g. Mount 1999). This 'Blame Culture in the UK, creates an environment where people are keen to point the finger at those who they believe are responsible for wrong doing. This culture takes the concept of accountability much further than the very ordered notion of legal accountability into the realm of public accountability, which knows fewer bounds. In this environment, the victims of bad management resort freely to the media of all kinds to help them to amplify their claims. They appeal to the media in its 'watchdog' role. In turn the media have created whole series of 'investigative' type initiatives to feed on this demand from those apparently wronged and the interests of consumers. Arguably this has produced a form of accountability which is acceptable to the public, particularly because it is speedy and cheap and it puts in place a means of redress which top management is beginning to respect.

Given this general background as to how managers actually appear to be handling their responsibilities and their increased accountability towards BRM, at a basic level the question can be asked – Have managers rejected a theoretical approach, informed by notional sets of principles and concepts in favour of a codified pragmatic approach manifested in the form of operational models? At an even more fundamental level, what is it that really drives them to take action to demonstrate that they have taken steps towards BRM? In particular, what is the relative importance of not conforming procedurally with what is expected and suffering the consequences in, either legal terms or perhaps public shame and blame through the media?

The Study

Six UK based businesses were selected on the basis that the study sample should, firstly, cover both manufacturing and service businesses and, secondly, small, medium and large businesses in terms, respectively, of sector and size. The industry sectors included in the study were: financial services, retailing, utilities and manufacturers of durable consumer goods. The businesses were selected on the basis of their fitting into the criteria outlined from data that was published about them. All the businesses approached were interested in the study proposal and agreed to contribute on the basis that anything that was published would be in a disguised and aggregated form. The sample businesses were asked to nominate for interview, top managers with particular responsibility for BRM. In each business interviewees typically identified were the Managing Director and/or the Finance Director as having key responsibility for BRM.

Prepared study guides were used as a basis for interviews that were allowed to be open-ended in order to collect contextual data. The findings were subsequently compared by the two researchers, any differences being resolved through further discussion with the interviewees. Hindsight rationalisation by interviewees was partially reduced by the longitudinal approach taken in the case preparation. Typically managers were interviewed, on a face-to-face basis, from each sample business on three occasions over a one year period. During the preparation of the cases and analysis several telephone interviews took place in order to clarify points and obtain additional data. Subsequently, managers from the sample businesses attended a workshop at which the initial analysis from the study was presented and discussed critically. This element of the research served not only to clarify the researchers' understanding, but also provided additional data. Further, secondary data was collected from sample business archive material and published material.

Findings

'New' management styles

Five of the businesses in the study sample claimed to be attempting to reduce both internal and external barriers and delegate power and authority to employees and one already claimed to have done so. The reasons for these actions included the need for speed, flexibility and cost reductions. At the same time, managements were attempting to shift the focus away from purely functional structures to 'across the business processes'. These new perspectives and examinations frequently called into question the continuation of certain kinds of activities that are not perceived as value adding. This move towards Business Process Redesign (BPR), improved efficiency and cost reduction was widespread amongst the companies in the sample. Paradoxically, the handling of BRM and the need to demonstrate compliance with related increasing numbers of rules and codes, caused costs to rise significantly, arguably without necessarily clearly adding value to the business.

All managers in the study were familiar with the notion of empowerment to one degree or another. Whilst, theoretically, this should involve delegating authority, accountability and responsibility away from top management to others throughout the organisation, this was not always the case in practice amongst sample businesses. Top managers were still sensitive to the reality that if risk did crystallise, the likelihood was that they would be involved and possible held accountable. Not surprisingly, therefore, managers, in practice, often only paid lip service to empowering the workforce. This is because they were fully aware that to empower the workforce is potentially to increase risk. These findings support similar observations made by Ezzamel et al (1994). One manager characterised his operationalising of empowerment in terms of 'an open and delegated management style which encourages commitment and personal accountability'. Other managers in our study characterised their philosophy as: 'trust is good but checking is better' and 'physical proximity is the best control you can have'.

Major concerns revealed by top managers in the sample businesses centred around the need to govern modern businesses, which have already embarked upon delayering and rapid growth, and are under severe pressure because of their inadequacies in relation to contemporary requirements and where time and administrative resources, particularly people resources, were severely constrained. The businesses in the study appear, therefore, unable to monitor as properly as they would wish, the sophisticated BRM systems which are increasingly required, through codes and compliance pressures of one kind or another (for example, Turnbull, 1999).

Although all the managers interviewed claimed to manage risk in a proactive way – it became readily apparent that approaches tend to differ from the small to the larger businesses. In the smaller businesses, where risk was managed often by the Managing Director personally, there was less reliance upon formally written policies and procedures and where such policies did exist they tended to be written by outside advisers. In these cases, the existence of the policy appeared to be the main comfort factor and not the operation of it. By contrast, in the larger businesses great store was placed on written policies and procedures. Top management in these businesses, expected employees to conform and believed that compliance is equivalent to protection from liability. Some tend to deny the need to apply and monitor the system adopted and the need to maintain a real awareness of their accountability, as it arises in relation to their respective roles, be they executive or non-executive directors. Once a recommended BRM system is in place, the study revealed top managers are often swamped by the size of the organisation and the complexity of the director's role.

Executive and non-executive directors distinguished

Both in practice and in theory, substantial distinctions exist between the strategic and operational roles and responsibilities of executive and non-executive directors. In the larger businesses studied, a diverse view appeared with regard to the usefulness of non-executive directors as an additional policing element for management strategy and policy development. One larger business welcomed non-executive directors as an extra dimension for control, acting as a useful sounding board and ensuring compliance. This business was relatively stable and bureaucratic and was keen to have non-executive directors with a relevant professional knowledge and expertise. This approach is consistent with the guidelines set down by the Cadbury Report 1992 and the Hampel Committee Report 1998.

On the other hand, another larger business in the sample which was very actively looking for new opportunities in which to invest and develop and which could be described as more entrepreneurial, adopted a different and more negative approach to non-executive directors. Its top managers complained, ''non-executive directors have no real chance of understanding properly what goes on''. They believed that ''they (non-executive directors) drive wedges in a business and can cause big problems''.[1] This business essentially sought to choose non-executives who will not interfere.

In so far as their respective accountabilities are concerned, what may in the past have been seen as very limited accountability of non-executive directors compared with executive directors is now changing, as highlighted in Dorchester Finance Co. Ltd and Another v Stebbing and others [1989] where the court held that the two non-executive directors of the company in question were liable in damages for negligent management of the company, together with the executive director. No distinction was made between the categories of director.[2] Non-executive directors, arguably, are not in as strong a position as executive directors in monitoring controls within the company and this ruling may place them in a position where they are increasingly vulnerable within their management role.

Public and legal accountability

All managers in the study stated that ensuring good public accountability, certainly in terms of media presentation of themselves as individuals and their respective organisations, was a main goal of their business risk strategy. The way in which particular individuals and organisations actually handled the threat of exposure by the media varied significantly.

In one sample business, where sales were handled by local agents, both local newspaper articles, whose adverse comments could severely damage sales to local people, and national papers, where coverage could significantly influence national institutional investors, were all carefully monitored and when necessary coping strategies were used to counter adverse publicity. In another sample business, where top managers were developing an expanding global business, their media handling capabilities had to stretch from dealing with relatively small incidents, which could attract local public interest, to major financial business disasters which could be on the other side of the world, which would attract the interests of global stakeholders.

Other forms of accountability were of more minor importance to top managers, though still considered. In particular legal accountability, with its well established framework for the operation of business and accountability, was nonetheless of much less importance as a goal for the actions of top management in our sample. When challenged about this, all managers commented that they believed that enforcement was so isolated that it was hardly considered worthwhile to build defences against it and indeed the cost versus the benefits in their eyes could not be justified.

Complacency, in so far as legal liability is concerned, may be a high risk strategy in itself for top management and corporations. Historically, the law has been slow to point the finer at top managers and indeed has been slow to hold organisations legally accountable. This attitude, together with procedural and technical difficulties often encountered in litigation and low standards of care being required of those involved in corporate governance, may have made this complacency justified. But there is evidence that the increased number of codes of practice, with detailed guidelines and higher standards for directors in carrying out their duties, lend themselves more easily to legal enforcement. These issues, together with recognition of the 'blame culture', already described, have given rise to the courts adopting new approaches to lapses in corporate governance. There is a distinct change to be seen in the moods of the courts (Mackay 1996, Godsell 1996 and Wells 1995).

This being said, top management may, it would seem, take some comfort, so far as legal accountability goes, from the para. 1.1 of the recent Hampel Committee Report (1998) which states:-

> The importance of corporate governance lies in its contribution both to business prosperity and to accountability. In the UK the latter has preoccupied much public debate over the past few years. We would wish to see the balance corrected.
>
> Public companies are now among the most accountable organisations in society. They publish trading results and audited accounts; and they are required to disclose much information about their operations, relationships, remuneration and governance arrangements. We strongly endorse this accountability and we recognise the contribution to it made by the Cadbury and Greenbury committees. *But the emphasis on accountability has tended to obscure a board's first responsibility – to enhance the prosperity of the business over time.* (Authors' emphasis)

Arguably, in the long term, this may have the effect of narrowing down what has become a sprawling range of corporate governance requirements, in so far as responsibility is concerned, by bringing much more to the fore, the prime responsibility, with which top managers traditionally feel most comfortable – i.e. creation of business wealth. This is also more congruent with the primary driver passed on to top management by external financial institutions. It remains to be seen whether or not this new stated perspective will again become the main criteria by which 'good' top managers will be judged.

Hampel may therefore be a watershed report, in that it may reverse the feeling of 'straight-jacketing' that top managers in the study complained of. This report, written as it is in more open and straightforward terms, may be more acceptable to top managers because of its leaning. While the focus of the Hampel Report is on Listed Companies only, it may be expected that its philosophy will diffuse out over time to smaller business as an icon of better practice.

Implications from the findings

Empowerment and vulnerability

The concept of empowerment of employees has attracted a lot of attention in recent years from academics, consultants and top managers. The concept is intuitively appealing, in theory, in that it allows not only workers in organisations to have richer experiences and commitment to organisational goals, while at the same time facilitating cost reduction, continuous improvements and corporate downsizing initiatives. These should lead to increased 'business value creation' and the meeting of 'shareholder value targets'. However, more detailed scrutiny of practice has already revealed serious misgivings about the claims for empowerment actually being achieved (Ezzamel et al, 1994). While all the top managers interviewed in this study accepted in theory that empowerment is an ideal that should be striven for, in reality they often only paid lip service to it.

In the smaller businesses studied, it was feasible, particularly for owner managers to avoid real empowerment and to continue to monitor personally all significant activities in the organisation and to have knowledge of these. Alternatively, in the larger businesses, top managers unable to personally manage all key activities, due to the size and often multi-location nature of their organisations, were driven to attempt to empower employees in the accepted sense. In fact they still remained concerned that they were properly managing all eventualities and risk. In an attempt to cover themselves they spent considerable sums of money on employing external BRM experts and investing in the requirements of extensive internal codes of practice and

Information Technology (IT) based management control systems. Around all of this, insurance consultants were available to advise on additional and extra levels and cover of insurance.

The danger in all of this is that managers believed that the setting up of sophisticated systems and procedures reduced the risk of their being held accountable, when business risk actually crystallised. In these situations, insurance may be of limited use in providing protection to top managers given the increase in areas of excluded liability by insurers in their policies in recent years which was forecast by Finch (1994). The reality is that large businesses currently are perceived as having 'deep pockets' and are therefore worth the time and expense of aggrieved parties pursuing litigation. It was detected amongst the owner managers of businesses in the sample, that this was not so in their case.

Dysfunctional effects of non-executive directors

Traditionally, non-executive directors have fulfilled a valuable role in businesses by acting as 'sounding boards' and accessing wider business and professional networks, without carrying with the role, the baggage of much accountability. All this, as was seen, has changed with new codes of practice and their interpretation giving rise to increased standards of care required of them by the courts.

As a consequence of all this and in order to better protect their position, non-executive directors are demanding more information about business operations and assurances that proper procedures are in place and constantly monitored and BRM has become a focus of their attention. These demands have in turn placed demands at the door of already stretched executive directors and other operation managers. This has inevitably altered the relationship between these two types of director to the extent to which in some cases non-executive directors are now perceived as part of the business problem rather than the solutions i.e. – 'a negative influence'.

The implications of this new relationship are that administrative costs are rising to meet the new demands of this police force of non-executive directors. Informal information flows are becoming inhibited as there is a perceived decrease in openness on the part of executive directors and employees, who now view non-executive directors as a potential threat to their modus operandi. Executive directors now feel under pressure to take these wider considerations into account when selecting non-executive directors and the danger of all this is that the latter will be chosen mainly for reasons other than their value in assisting the leadership of the business.

The media and the Blame Culture

Currently the media plays a significant role in regulating the behaviour of top management. Uniformly in the study sample, executive directors exhibited concern that they and their businesses would be widely held publicly accountable by media reporting of all kinds, for their poor management when risk crystallises. This is a very effective means of regulating business activity because of the ability of the media to dig deep into the centre of business strategy and operations and to expose the organisation and its employees. Arguably the power of this deterrent is the size of the audience, which may include customers, suppliers and stakeholders both nationally and internationally and this can have a very damaging long term effect on the business. Whereas legal accountability fits into a carefully considered and constrained set of rules and procedures, media investigations and publicity is not so predictable and constrained. Any miscarriages of justice by the media re unlikely to attract similar exposure because of the tradition of media self-regulation.

Concluding comments

There is a diverse range of understanding of BRM by top management and how it fits with overall corporate governance requirements. Not unsurprisingly, the approaches to BRM adopted by top management which were observed in this study of UK businesses could be said to range from the extremely naive to the very sophisticated. In part this may reflect a general lack of knowledge about BRM practices and procedures by some and a recognition by others that little may result from crystallisation of risk to them personally or their businesses, particularly so far as legal enforcement is concerned. However, of much greater practical concern to top managers in the study were the effects of the current 'Blame Culture' that has developed in the UK and how the crystallizing of risks will affect corporations and individuals involved in managing them, when exposed in the media.

The move in the Hampel report to balancing responsibilities of top management between value creation and good corporate governance appears to suggest more scope is offered to top management to pursue value creation strategies with a reduced expectation of legal accountability. However, it remains open to question as to whether this will reduce legal enforcement in a climate where there has been a public mood swing in the UK towards increased legal accountability. It remains to be seen how widespread and effective the recommendations of the guidance of the Turnbull Working Party (1999) become that listed companies should have established risk management procedures in place by the end of the first accounting period ending on or after 23 December 1999. This will be an interesting area for further study of the mechanisms of diffusion of best risk management reporting practice.

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Notes

1. The Hampel Committee Report (1998) on this point believes the danger of this division between executive and non-executive directors has arisen as a result of the Cadbury Report (1992) paragraph 4.10 emphasising the monitoring and control function of non executive directors. On the other hand the Hampel committee believed that executive directors should ''be able to work with them (non-executive directors) in a cohesive team to further the company's interests.''
2. However, as the Hampel Committee Report (1998) notes, paragraph 3.3 ''the English Courts have recently tended to take into account such factors as the position of the director concerned (e.g. whether or not he or she is a full time executive director or a non-executive director). This appears to leave in some doubt the true position of non-executive directors' legal accountability.

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