CONVERSATION STARTER

Looking through the risk lens –

Building reputation and resilience into the business model

A discussion paper from Airmic and CIMA's project on risk and the business model – the big idea in risk

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airmic

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INTRODUCTION

More than ever before, company boards need to understand risk if they are to ensure the long-term sustainable success of their organisations and to avoid the pitfalls that have tripped up so many, ranging from financial product mis-selling to passing horsemeat off as beef. There is no shortage of ‘risk stories’: for example, Airmic’s Roads to Ruin report includes 18 case studies that analyse major corporate crises, such as Northern Rock, Airbus and BP. In every case, it appeared that boards were failing to engage with important risks, including risks to reputation. This discussion paper aims to provide a conversation starter on how boards can address this deficiency by using their business models to shape an effective risk conversation.

There is little doubt that the challenges of globalisation, digitisation and new technology combined with the sheer pace of change are putting more demands on boards. In particular, they need to understand how the value of their organisations lies increasingly in intangible assets, such as brand, reputation and customer sentiment, reflecting a shift towards the ‘experience economy’. They also need to grasp wider stakeholder needs and demands, including the impact of social media.

However, evidence suggests that many are frustrated that they lack the right tools and information to enable them to have an effective risk conversation that focuses on building resilience and protecting reputation in this new environment. For example, a recent McKinsey survey revealed that directors ‘struggle to understand and make time to manage business risks – one of several areas where directors indicate room for further improvement’[1].

> “While respondents say their boards are taking more responsibility for strategy, risk management is still a weak spot…This is the one issue where the share of directors reporting sufficient knowledge has not increased: 29% now say their boards have limited or no understanding of the risks their companies face. What’s more, they say their boards spend just 12% of their time on risk management, an even smaller share of time than two years ago”
>
> *Improving board governance: McKinsey Global Survey results, August 2013.*

While risk management has developed significantly in recent years, a new integrated approach is needed, which provides a complete and coherent picture of the organisation’s risk universe.

[1] Improving board governance: McKinsey Global Survey results, August 2013.

We believe that organisations can achieve this by viewing their business model through the lens of risk – and within the context of the external environment.

This discussion paper provides a proposed framework for integrating risk through the business model, together with a structured approach to the effective board risk conversation. We will be testing this model through further research. It complements the recent report, Tomorrow's Risk Leadership: delivering risk resilience and business performance, which makes the case for all organisations to rethink their risk leadership and consider the value of a dedicated executive risk leadership role.[2]

[2] See www.tomorrowscorporategovernance.com. Both Airmic and CIMA contributed to the development of the report and toolkit.

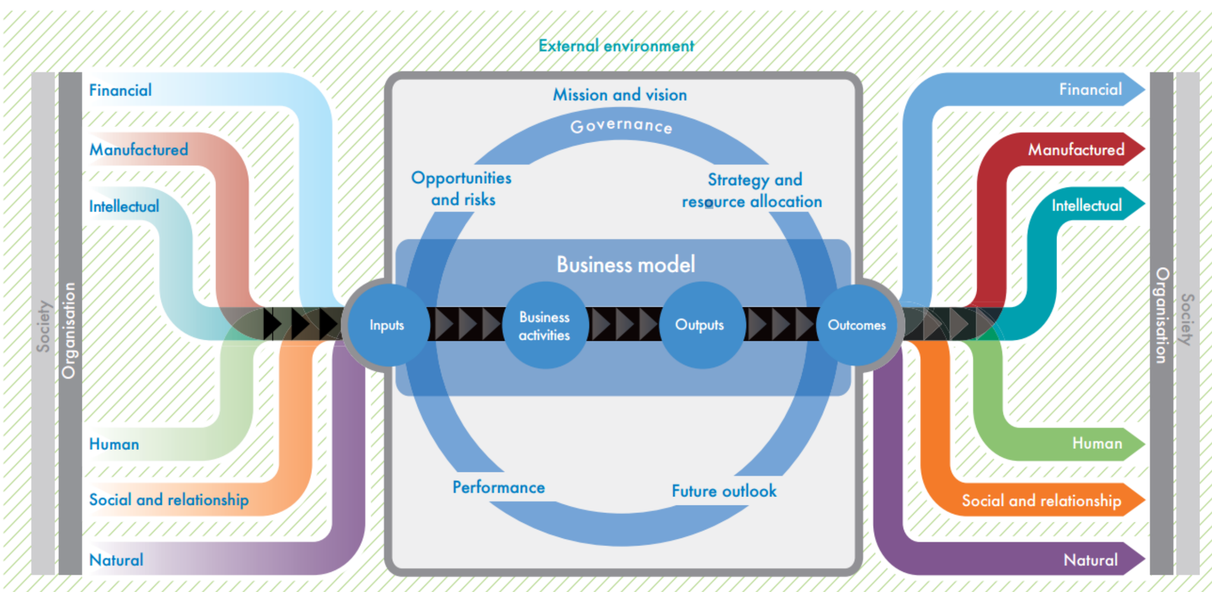
INTRODUCING THE BUSINESS MODEL

Our framework is underpinned by the concept of the business model, defined in the International Integrated Reporting Framework as the organisation's 'system of transforming inputs, through its business activities, into outputs and outcomes that aims to fulfil the organisation's strategic purposes and create value over the short, medium and long term'.

A thorough understanding of the business model within the context of the external environment provides a sound basis for identifying risks and opportunities.

The inputs and outputs of the business model are expressed in terms of the 'six capitals' – the organisation's key resources and relationships: financial, manufactured, intellectual, human, natural, and social and relationship. This ensures a broad, integrated view of value creation which takes intangibles as well as 'externalities' into consideration.

Figure 1: the business model shown as the value creation process within the context of the external environment



<IR> framework showing the business model at the heart of the organisation © IIRC 2013

Setting the risk context

The business model needs to be applied to a robust risk management process. This is illustrated in Figures 2 and 3, which show an iterative cycle of setting the context against which risks can be assessed, treated and subsequently monitored and reported upon. The board has a key role to play in this process. For example, the UK Corporate Governance Code indicates that the board needs to monitor the effectiveness of the risk management process as a whole. It also makes clear that the board is responsible for setting the overall risk context in terms of determining the nature and extent of the principal risks it is willing to take and it must also monitor and report upon these principal risks. These include risks that would threaten the organisation's business model, future performance, solvency or liquidity.

Figure 2: The risk context

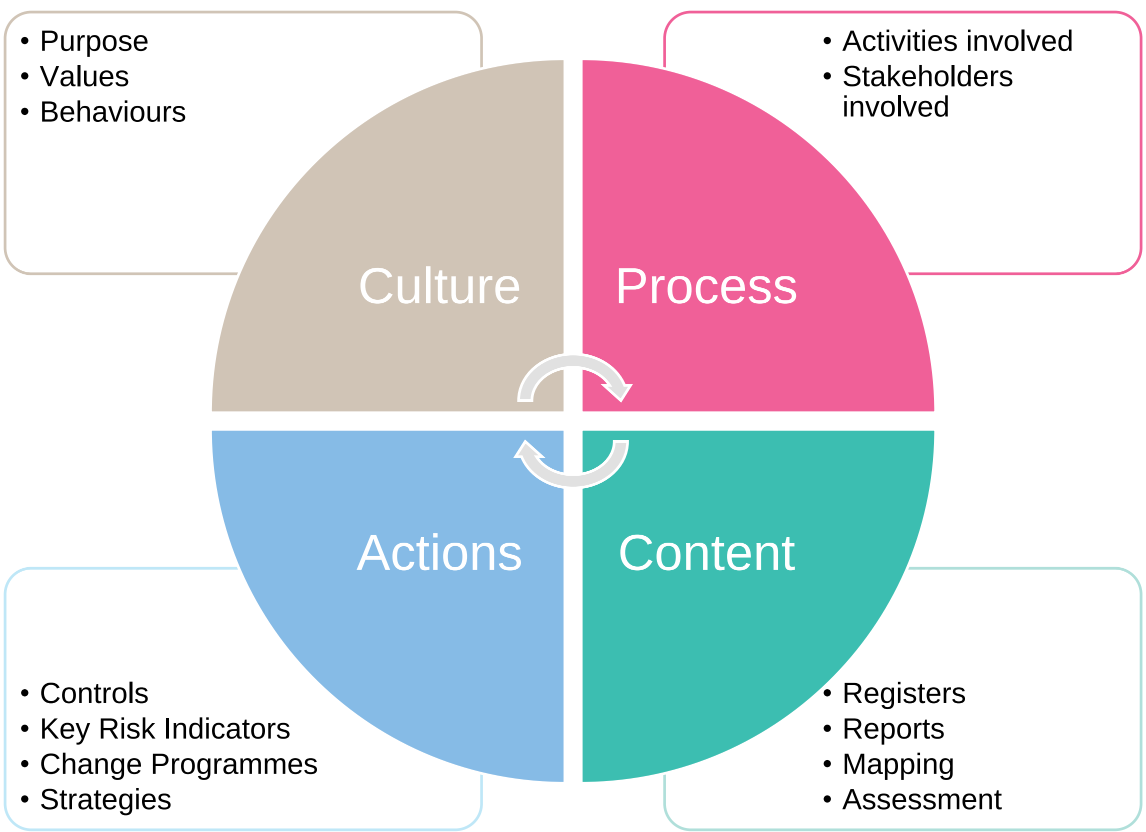
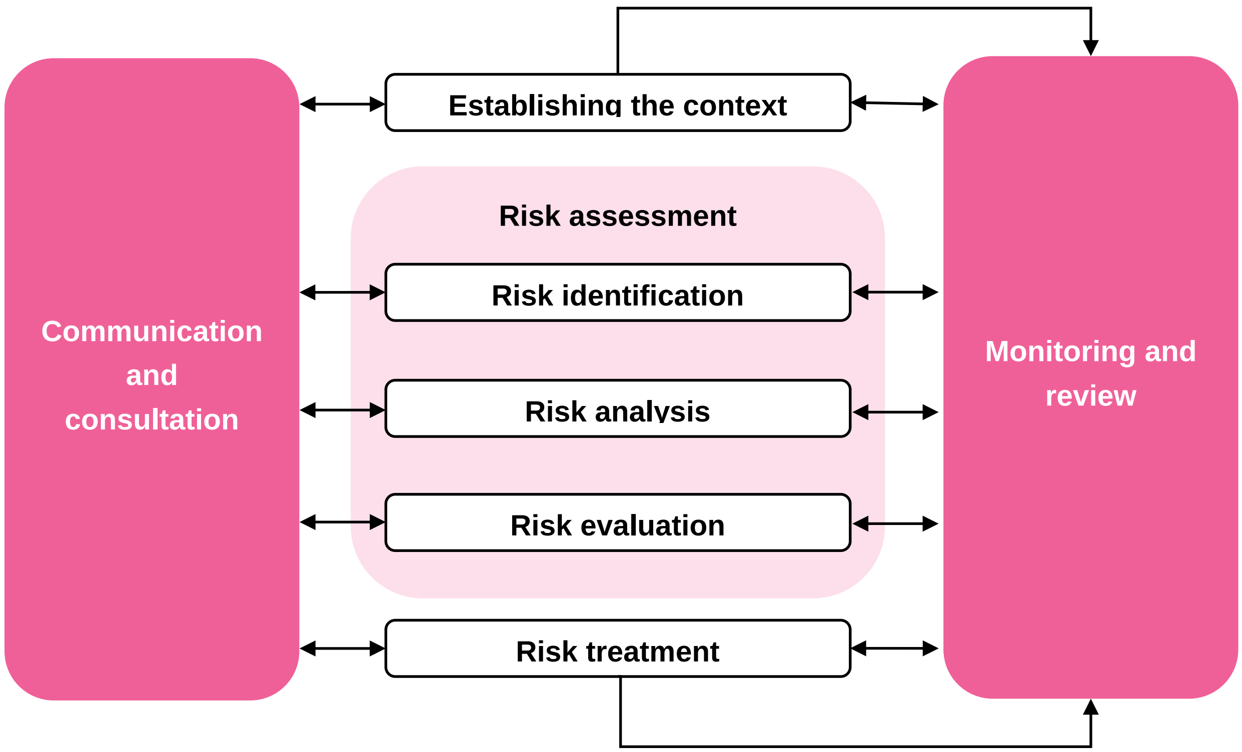


Figure 3: The risk management process – including the risk context

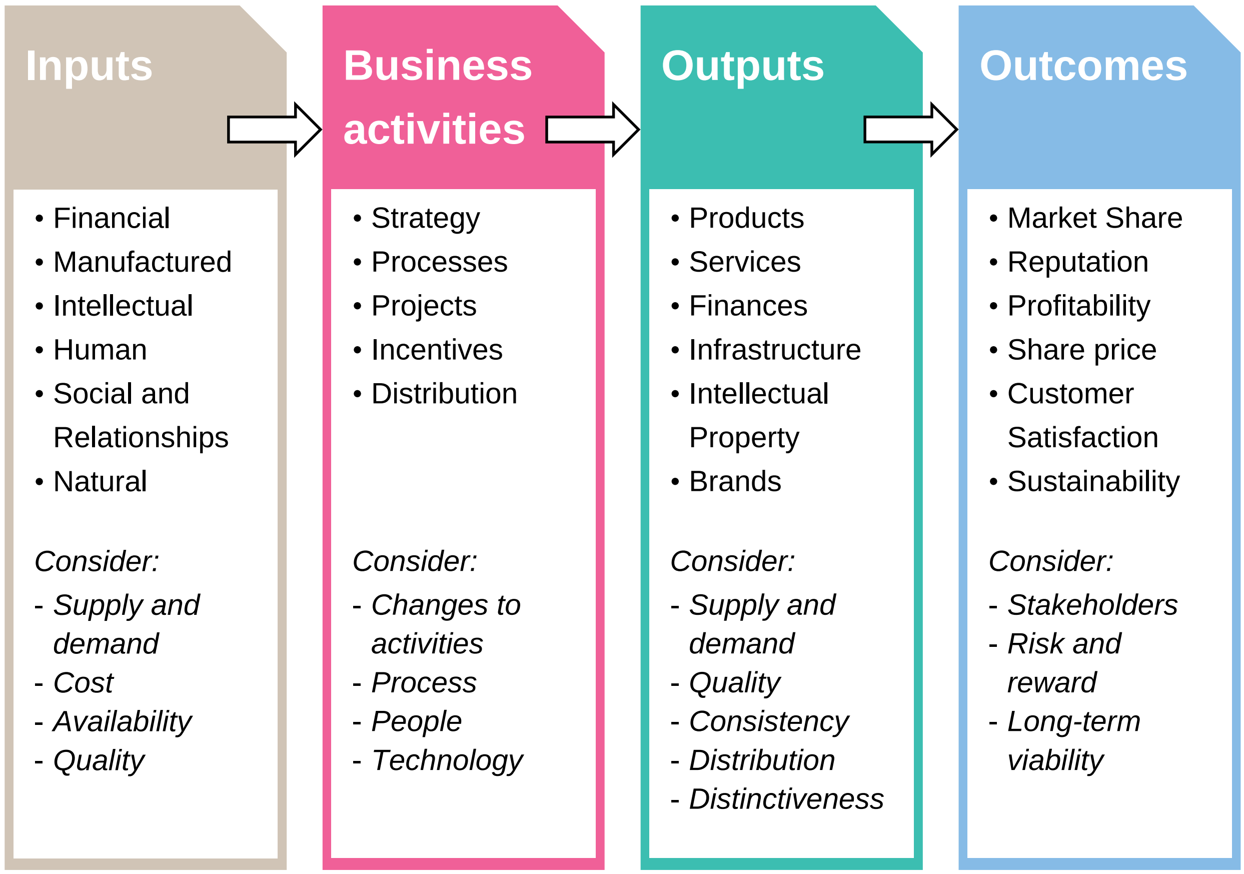


Risk assessment

An essential element of the risk management process is risk assessment. Typically, a risk register is developed, identifying a series of possible 'risk events'. The benefit of using the business model as the basis for risk identification is to ensure that risks are viewed in an integrated way over the short, medium and long term. This should help the board to better understand cause and effect, giving it greater assurance that it has line of sight over all the principal risks. For example, understanding the quality of key 'inputs' such as people or relationships may help the board to assess whether the organisation is setting up potential problems for the future, such as mis-selling, poor customer/patient care or industrial accidents. An events-based risk register might not pick up such broad-based risks that may play out over the longer term.

A more systematic approach is to use the four components of the business model (inputs, business activities, outputs and outcomes) as a basis for identifying risks within the context of the external environment:

Figure 4: managing risk through the business model



This process of identification creates the basis for an integrated risk analysis and evaluation, which informs how the risks need to be managed.

Figure 4 shows that risks need to be identified for each component of the value creation process. For example, in relation to inputs, each of the six capitals need to be considered in terms of cost availability and quality. The outcome of this process is a systematic identification of all the risks related to inputs, business activities, outputs and outcomes: Figure 4 shows the key considerations relating to each category.

These key considerations can then be integrated and analysed to create a principal risk narrative. For example, an organisation may identify a risk that it is not able to access talent in sufficient numbers with the required skills to deliver its services effectively (a risk to an input). It can track this risk through the business model by connecting it to the risk of process failure (risk to business activity), resulting in poor service delivery (risk to output) and ultimately, damaged reputation (risk to outcome). This process should also flush out risks that have been missed. It should also enable risks arising from the different capitals to be integrated, for example poorly-trained people combined with inadequate equipment may result in poor customer experience and at worst, serious accident.

This process of integration enables a richer risk assessment by:

- Identifying recurring or particularly strong risk themes, for example, safety.
- Developing a more comprehensive understanding of causes, effects and consequences, leading to more complete risk responses. For example, an organisation may address the risks of poor service delivery by investing in staff training, which may prevent short-term problems. However, in the longer-term, it may be necessary to address the talent issue at a deeper level by collaborating with education providers, automating processes and/or outsourcing some activities.

Based on this risk analysis, therefore, the organisation can determine appropriate risk responses over different timescales and at three levels:

- Strategic
- Tactical
- Operational.

Some risks will be relatively simple, demanding a relatively straightforward operational response. Others, like the example above of poorly-trained people combined with inadequate equipment, will benefit from being viewed through the lenses of the different capitals across all components of the business model to generate appropriate risk responses at the strategic, tactical and operational levels.

THE BOARD RISK CONVERSATION

How does this detailed risk assessment inform the board risk conversation about principal risks?

Based on the above risk management process, management should be able to determine what risk information is material for the board report as follows:

1. **The risk management process, including the risk context.**

   Conversation points:
   - *Setting the context and tone from the top*
   - *Is the risk management process effective?*
   - *Are we picking up all the principal risks?*

2. **Report on the recurring and dominant risk themes e.g. safety.**

   Conversation points:
   - *Would we expect these to be dominant themes for our business?*
   - *Are there other dominant themes we should reasonably expect to see? What are we missing?*
   - *Are the risk responses consistent with our risk appetite and risk culture?*
   - *Is our risk culture giving rise to these risks? Are we getting people to do the right thing?*

3. **Report on key business model risks.**

   Each headline risk would be supported by a strong narrative, which explains detailed causes and consequences, integrating all aspects of the business model and indicating a range of risk responses at the strategic, tactical and operational levels. These risks would form the main part of the board risk conversation and would need in-depth discussion, relating the risks to risk culture and appetite as well as changes in the external environment.

   Conversation points:
   - *In view of these risks, is our business model fundamentally sustainable?*
   - *Are we comfortable that we are not risking catastrophic loss?*
   - *What metrics do we need to monitor these risks?*
   - *Are these risks and proposed responses consistent with our risk appetite and culture?*
   - *Is our business model giving rise to additional risks? Are we encouraging the right behaviours?*

What the board receives is integrated and focused risk information that is underpinned by the logic of its business model, which should help it spend its time on the risks that have the greatest potential for damage. By using the business model as the basis for the risk identification process, boards also avoid the trap of focusing only on strategic risks and missing operational disasters that cause reputational damage. As we saw above, risks identified through the business model should be considered on every level – strategic, operational and tactical.

Would this approach prevent some of the problems that were so graphically described in *Roads to Ruin?* For example, would the board of Northern Rock have received a risk report that highlighted the risks to its business model inputs of financial capital and how this might play out for its business? Could such a risk report have led it to conclude that as it stood, its business model was unsustainable? Could a business model-based risk report have helped the BP board to conclude that safety was being compromised? Difficult to say, but we believe that a crucial first step is to ensure that, at the very least, this sort of information is presented to the board to enable the right conversation on risk to take place.

Questions for discussion

- Does this approach make sense and would it be workable on a practical level?
- How can it be improved?
- To what extent will it support a more integrated conversation on risk and resilience?
- How do you think this model could be developed?

This discussion paper is the basis of research that Airmic and CIMA are initiating on risk and the business model and aims to 'start the conversation'. We would be interested in hearing from organisations that would be willing to participate in the further development of the business model approach to risk management and reporting.

About CIMA

The Chartered Institute of Management Accountants (CIMA), founded in 1919, is the world's leading and largest professional body of management accountants, with over 218,000 members and students operating in 177 countries, working at the heart of business. CIMA has formed a joint venture with the American Institute of CPAs (AICPA) to establish the Chartered Global Management Accountant (CGMA) designation. CGMA is the global quality standard that further elevates the profession of management accounting. The designation recognises the most talented and committed management accountants with the discipline and skill to drive strong business performance.

For more information about CIMA, please visit www.cimaglobal.com

About Airmic

Airmic is the UK association for risk managers and insurance buyers. Its membership includes 75% of FTSE 100 companies.

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