A Look Into ERM

ERM IN THE HIERARCHY OF CORPORATE NEEDS

BY DAVE INGRAM

QUITE OFTEN, the proponents of a new business management theory will oversell the importance of their ideas. Firms that want to be known as forward thinking will accept these overblown descriptions and subject their companies to wave after wave of new and better ways to order pencils or arrange desks.

Enterprise risk management (ERM) is no exception.

Proponents of ERM will talk about how the culture of the entire firm needs to be adapted to conform with this über-important new discipline. The capital models that are at the heart of an ERM program are required to be at the center of the strategic planning process of the firm.

As has happened to other new business management ideas, ERM is often oversold. And with that exaggeration of the importance of ERM, we risk it joining many other ideas as a passing management fad.

ERM needs to be seen in perspective of the other management priorities. Like the human needs articulated by Maslow, there is a hierarchy of corporate needs and ERM is not first on that list.

ATTRACTIVE PRODUCT

The first need of a corporation is to have a product or service that someone will buy from them. Simply put, a company must have sales. That this is the first and most basic need of all corporations is often lost from sight, perhaps because the corporation has had sales for many, many years. But any person who founds a new company will very clearly remember when they were first sure that they had found their something that customers would buy. No company can exist for any length of time without sales.

REASONABLE PRICING

The second need is for the business to have the capability to create that product or service at a cost that is lower than the price that customers will pay—a profit. As products and services go through cycles of demand ebbs and flows, companies that had achieved their profit may be challenged to stay profitable. Of course, a company cannot continue in the long run without a fundamentally profitable business.

Once a company has sales and profits, that company has the potential to be valuable. But one more thing is needed for that company to actually be valuable—the ability to stay in business in the future and repeat the process of making sales at a profit. These first two needs of companies and the ability to continually meet those needs should be of the highest concern to the executives and boards of firms.

PROFITABLE SALES

The third corporate need is that repeatability of sales and profits. That is where ERM comes into the hierarchy of need—in third place. When the business has the ability to repeat the process of profitable sales, then the business has a value. ERM is the comprehensive process for defending that value. Once the decisions have been made regarding how to go about making sales and profits, the role of ERM is defensive. Corporate value is a function that combines all of the first three needs—amount of sales, profit per unit of sales, and likelihood of achieving the sales and profit. To satisfy the level 3 corporate need, ERM usually focuses on maintaining or improving the likelihood of achieving a profit.

The defense of sales is often completely separated from the defense of profits. Some risk managers have named that process strategic risk and seek to include it within

ERM. In many firms, defense of sales is a more longstanding and better-staffed function than ERM.

When a firm has a value, the fourth need comes into play—the need to increase that value. A company can increase value in three ways: by increasing sales, by improving profits per unit of sales, or by increasing the likelihood of achieving the future sales and profits.[1] In some circumstances, there are options that exist for a company to improve one of these three elements at minimal cost to the other two, but those options are rare. In most cases, companies must make a trade-off. It is in deciding on those trade-offs that ERM can provide unique insights about how decisions will impact upon the likelihood of achieving future profits.

WHAT ARE THE TRADE-OFFS?

This ability to systematically and quantitatively evaluate the trade-offs *is* an exciting new addition to management's capabilities that ERM can bring to the table. It is the capability that drives the process that S&P refers to as strategic risk management. To many practitioners, this capability *is* ERM.

But risk managers need to understand the place of this capability in the hierarchy of needs. It does not help at all in achieving the highest-priority corporate need for sales. This capability is expensive and therefore works against the second-priority corporate need of profits. This capability is not specifically predictive and therefore provides limited assistance with the third-level corporate need of sustainability either. This capability to determine the value trade-off of strategic alternatives comes into play to satisfy only the fourth-level need of value growth.

Companies that are struggling with satisfying their level 1, 2 and 3 needs will not be particularly interested in spending the time or money required to master this practice. These companies may have appointed risk managers with hopes that they would concentrate on the level 3 need for very specific security of profits. Outside analysts who see a firm struggling with achieving consistent profits will consider the lack of profits to be the most pressing risk of the firm.


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So before charging forward with the intellectually and professionally satisfying activities of modeling risk and assessing strategic alternatives, risk managers need to be clear on where their firms stand in terms of satisfying their corporate needs—and how the risk management discipline can assist with any that are unmet. ■

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END NOTES

[1] See Panning, W. Managing the Invisible, *NAAJ*, 2013.

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