

## Risk-Based Performance Improvement (RPI)

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Companies today are focused on managing their risks and improving performance on a daily basis to increase profits and create shareholder value. However, reality shows that performance management initiatives and risk management activities are frequently not harmonized.

Performance management is a key task for people who manage the business and make decisions at all levels of the organization, ultimately trying to achieve company objectives. Risk management, on the other hand, often involves executive management, risk managers, compliance officers, and/or internal auditors. These managers are typically employed at the corporate level and are often not involved in day-to-day business operations. However, performance management and risk management can complement each other and can result in improved company performance and the creation of shareholder value.

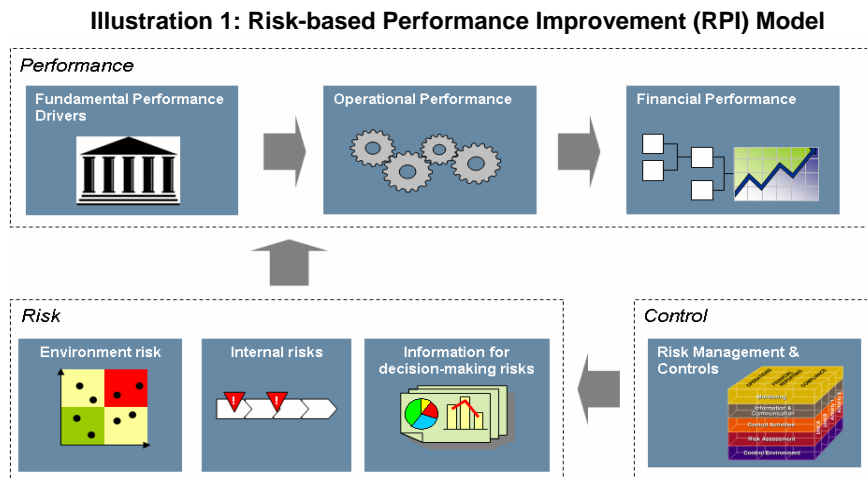
### Risk and Performance Drivers

The basic principle of Risk-Based Performance Improvement (RPI) is that financial results are determined by operational performance, which is, in turn, the result of fundamental performance drivers such as a clear strategy, an experienced and competent management team, and a results-oriented culture that employs motivated people. These performance drivers are exposed to uncertainties and risks—both external and internal—that need to be managed and controlled.

Three key sources of uncertainty often include but are not limited to:

- *Environment Risk* - Uncertainties that affect the viability of the business model.
- *Internal Risk* - Uncertainties that affect the execution of the business model.
- *Information for Decision-Making Risk* - The risk that information used to support strategic, operational, and financial decisions is not relevant or reliable.

The relationship between performance management and risk management is illustrated in the following RPI Model.



To implement an RPI framework and develop a process for improving business performance, consider the following steps.

1. *Translate Company Objectives into Financial Performance Drivers and Key Performance Indicators (KPIs)*

RPI starts with translating company objectives into the most important financial objectives and related performance indicators. These are frequently translated into measures such as revenue growth, operating profit, or ROI. A company may also use value-based performance indicators such as economic value added (EVA).

2. *Identify Operational Performance Drivers and KPIs*

Identify logical cause-and-effect relationships to determine which key operational factors most impact financial results. The challenge here is two-fold.

First of all, financial results are determined by many factors. Therefore, it is important to only select the operational factors that have a significant impact on financial performance. These might be the number of client complaints, days sales outstanding (DSO), delivery times, or inventory levels. Less common measures may also be relevant, such as the progress of an international outsourcing project, the implementation of a large IT system, or the effectiveness of a post-merger business integration process. Not all operational performance drivers are easy to measure or to express in a KPI, but they frequently have a significant influence on process effectiveness, employee productivity, or customer satisfaction.

Secondly, the organization must understand the inter-relationship and reciprocal dependencies among the operational factors. For example, manufacturing errors in the Production Department make it difficult for the Sales Department to sell the product, or make it necessary to reduce the sales prices. On the other hand, the wide product portfolio determined by the Sales Department, together with the acceptance of both large and small sales orders, often means that production staff must continually reset the machinery in the factory. This increases the probability of production errors.

3. *Identify Fundamental Performance Drivers and KPIs*

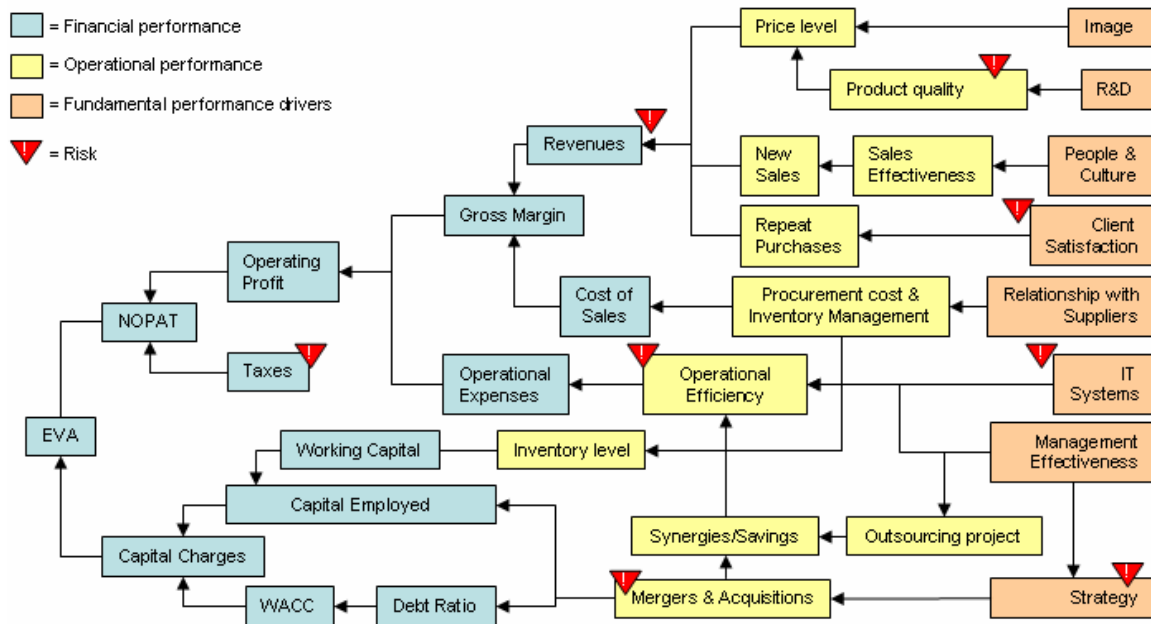
Think about the underlying factors that drive operational performance. These fundamental performance drivers relate to areas such as strategy, management, organizational structure, culture, information systems, and people. Aspects such as the complexity of the organization, relationships suppliers, and strategic partnerships may also be regarded as fundamental factors in determining future performance.

The fundamental performance drivers can also be seen as a corporate health report because they refer to the organization's (non-tangible) assets and competencies to sustain performance and grow the business over the long term.

4. *Identify Performance-Related Risks*

This is often viewed as the most important step in identifying key risks that directly affect the performance drivers. These risks could have a negative impact (such as the loss of a major customer) or a positive impact (such as a decrease of purchasing prices) on the organization. The risks and their relationship to the performance drivers are displayed in the following illustration.

Illustration 2: Risks and Performance Drivers Example



### 5. Execute a Risk Assessment

In this step, the organization determines the probability or likelihood that the risks will occur. The company also determines the impact of the risk on the performance driver. This step does not just prioritize risks; it also shows the sensitivity of the performance drivers to the risks. The starting point is the current situation basing the risk assessment on the controls in place today.

### 6. Key Risk Indicators (KRIs)

Define the key risk indicators (KRIs) that determine the risk source. It is quite common that the information needed to calculate the risk indicator is already available, but not being used for this purpose. To minimize this, organizations should use information from existing systems as much as possible and avoid the manual generation of KRIs.

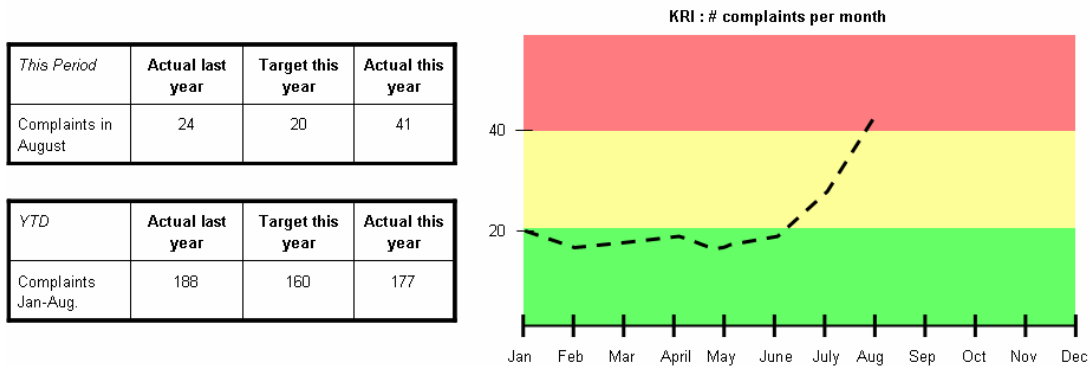
For example, a company may use days-sales-outstanding (DSO) as an operational performance indicator. A decline in customer satisfaction is a risk that might affect customers' payment behavior. The organization can use periodic customer satisfaction surveys or trends in the number of complaints as the risk indicators. The source of the issue might be that prices agreed by sales managers are not clearly established in the CRM system and customer orders are then processed at an incorrect price by back office staff. In this case, the organization can implement periodic risk assessments or system audits to help resolve the problem.

### 7. Risk Reporting

Once KRIs are determined, the organization should integrate them into the monthly management reporting process. The Business Control or Financial Planning and Analysis (FP&A) functions are often the appropriate source for providing reports. It is important to analyze and explain the differences

between the actual KRI value and the standard (desired) KRI norm. The following illustration is an example of how you can communicate this type of analysis.

**Illustration 3: KRI Example (Number of Complaints)**



**8. Identify Control Gaps**

Identifying and reporting KRIs is only one part of the process. The other side is to identify risk management measures and controls that mitigate the risks. A control gap exists in situations where a control is missing, or is not operating as intended. It is important to identify and summarize these controls needing improvement.

**9. Develop Complementary Risk Management Measures and Controls**

When control gaps are identified and documented, it is important to evaluate the nature and severity of identified control gaps. This will help prioritize the deficiencies requiring action and will allow management to decide if remediation is necessary. If management decides to address the control gap, the organization should develop the necessary control(s), or re-design current control(s), to mitigate the associated risk(s). This enables the company to fill the control gap and lower the risk when the control is designed properly.

**10. Control Effectiveness Assessment**

Do not ignore the organization’s control structure. Periodically assess the effectiveness of the controls currently in place. The company may interpret this as having to perform control testing, but this is not always necessary. It is also possible to perform a self-assessment or review appropriate company-level controls. Choose the option that is the best fit for your organization and its risk environment. However, remember that the best solution does not always translate into the quickest or cheapest solution. Quality risk management practices require quality maintenance.

### **An Integrated Effort**

Risk management not only protects an organization's value, it also helps create it. For this reason, risk management should not be positioned within the company as a compliance process or a value-protection function that only delivers detailed flow charts and extensive risk and control matrices. Bring it to the forefront of the business.

It is a natural part of operations *and* finance. The finance function is an important linchpin between analyzing and reporting business performance while also monitoring and managing risks. This means that the CFO, corporate controller, FP&A manager, or management accountant each has an important role to play in this effort. It is not restricted to line managers.

Performance management and risk management complement one another and effective integration contributes to improved business performance. Marrying these two processes improves the financial and operational performance of a company, both in the short term and long term.

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