Chapter 2
Governance and Risk Management

2.1 Three Interpretative Models: The Paradigm of "Structure-Conduct-Performance", "System Theory", and "Value-Based Management"

For the purpose of defining the risk management action area, three important managerial analysis models are:

- structure-conduct-performance paradigm and the functional view of risk management;
- systemic approach and transversal/process view of (risk) management;
- value-based management and value perspective.

2.1.1 The North-American School and the Structure-Conduct-Performance Paradigm

Until the 1960s, in North America the environmental and competitive context was such as to reward the large multi-division business model: just think of General Motors, Standard Oil or Du Pont, which embodied managerial best practices and where the greatest management thinkers of that period operated (e.g., Alfred Sloan and Peter Drucker in General Motors).

In this context, managerial studies focused mainly on the ability to harmonize the "forecast, planning, organization, control, coordination and monitoring" moments which were the foundations of the managerial paradigm of *structure-conduct-performance* (Ansoff 1965; Drucker 1946). According to Chandler's and Galbraith's theories, whereby "structure should follow strategy", the strategic development decisions, such as, for example, vertical integration or diversification, should be made through centralized planning capable of "guiding" the restructuring of the organization. Only a few years later, Schumacher began to observe that every multi-division structure, such as General Motors, in fact would resemble

A. Borghesi and B. Gaudenzi, *Risk Management*, Perspectives in Business Culture,
DOI: 10.1007/978-88-470-2531-8_2, © Springer-Verlag Italia 2013

a "federation of reasonably large businesses": here Schumacher was perhaps the first exponent of a new current of thought that gave small business a positive connotation for business competitiveness (Schumacher 1973).

This model focused on individual organizations, governed by the principles of an infallible *scientific management* capable of ensuring a "natural" balance, according to Fayol's description, between strategic planning and its implementation at all levels of the organization (Drucker 1974; Chandler 1962, 1977; Fayol 1949; Taylor 1947).

This cultural and managerial context gave rise to the early approaches to risk management as planning and implementation of risk control techniques through, typically, the tool of insurance transfer. Indeed it is in this managerial context that Mowbray et al. (1979), some years later, also distinguished the concepts of *speculative risk and pure risk, which were briefly introduced in the previous chapter* (Carter and Doherty 1984; Giarini 1982):

1. *The speculative risks* are those that can generate alternatively, either gains or losses. In this context we can refer to risks linked to financial management and strategic choices associated with the business activity, which are capable of generating profits, but also conversely, losses. We can think, for example, of risks linked to events and choices such as production delocalization, changes in the structure of production costs or loans, the failure of new technologies or new products, the reduction in sales or market share, competitors' actions, or, in general, socio-cultural, political or regulatory changes.
2. *The pure risks* are those that can generate only losses. We can name for example: interruptions, failures, or breakdowns of production equipment; thefts, fraud or other malicious acts; catastrophes; accidents to people, illnesses or death.

In this economic and social context there developed, as we will see later, the **functional approach** to risk management, based typically on insurance products.

2.1.2 Business as an Open System and the Systemic Approach to Business Governance

Among the founders of the systemic approach we should first mention Emery (1969) and the biologist Ludwig von Bertalanffy (1969) who analyzed and embodied the different approaches to the systems theory (in the subjects of biology, physics, sociology, economics, and business organization), and described the open and closed systems in relation to the environment as well as their respective operational dynamics.

This line of thought highlights the systemic nature of a business, meaning that each organization represents a "system" belonging to others and in turn is made up of sub-systems, thus developing an intrinsic synergy.

From this we can draw the **following principles**:

- organizations belong to larger systems that encompass them, such as, for example, the reference environment or–from other perspectives–the sector, district, industry or value chain;
- organizations include internal sub-systems such as decision-making units, functions and processes;
- the organizational structure of a corporation is expressed by its network of internal and external interactions.

The environmental changes that occurred during the 1970s and 1980s impacted to a significant extent on the features and nature of demand, production processes and competition dynamics. All this has entailed for businesses the need to confront themselves with a significant evolution of the "parameters" of excellence and competitiveness (Peters et al. 1982; Peters 1987; Mintzberg 1989), thus highlighting the need to review and transform the rigid hierarchical/top-down, yet transversal structure (from which the identification and management process of the distinctive skills should stem).

This economic and social context witnessed the consolidation, as we will see later, of the **transversal approach** to risk management, based on risk identification, assessment and treatment tools which, rather than being only insurance-based, were drawn from different business environments (Committee of Sponsoring Organizations of the Treadway Commission (COSO) 2002–2004).

2.1.3 Value-Based Management

Value Based Management (VBM) is the management approach that ensures that corporations are run consistently on value (normally: maximizing shareholder value).

The three basic elements of VBM are:

1. VBM is permeated by the principle that value creation is the primary aim of the business;
2. VBM means making decisions, allocating resources, remunerating management with the aim of creating value. The ultimate purpose is to make sure that at each level of the organization, management is encouraged to act as if it were the owner of the business;
3. VBM is a tool for assessing the success or failure of the management activities that are in their inception phase or that are being implemented. VBM is a tool for anticipating what contribution a certain activity will be able to make to value creation.

The main feature of Value-Based Management is that all the decision-making processes, planning, and the control systems are strictly related to the objective of maximizing value creation for the shareholders.

Managing with a view to creating value begins with the strategy and ends with the financial results: Management is responsible for creating the link between strategy and results. The mission of every business is to create value. This new imperative gives rise to strategies, organizational models and new management systems that, considered as a whole, give rise to the concept of Value-Based Management.

This vision is an essential contribution for interpreting the Risk Management process, whose objective is indeed **the protection of the business from unfavorable events in order to maximize its value creation capacity**.

2.2 Governance and Value Creation

Consistently with the systemic view of the business and the VBM, the body charged with the governance has the task of setting up and guiding development actions, i.e., the system evolution dynamics. Furthermore it develops the coordination of and with the sub-systems, as it is responsible for both ensuring the economic objective of maximizing value creation and complying with a "social task": the balance of interests and the social legitimization with and from various public reference models.

In the current environmental context, the roles of the governance body and the boundaries of governance change: the push from globalization leads to competition among business networks and no longer between individual businesses; the competition excellence levers are increasingly reaction speed and innovation (time) and the optimization of the cost/quality ratio of the product/service. The need to simultaneously manage diverse and at times opposing strategic objectives encourages businesses to take on increasingly greater levels of risk. Therefore, the conditions of riskiness are linked to both the environmental context and the strategic and managerial choices made by businesses.

Stakeholders have more and more access to information and demand greater transparency and responsibility from businesses. For these reasons the role of compliance has increased significantly in importance. This role includes compliance with regulations and the proper disclosure of corporate choices to stakeholders.

To this end the Corporate Governance system should introduce voluntary rules (codes of conducts and self-regulations, resulting from the internal control system) or a systematic approach to monitoring compliance with the rules.

The purpose is to ensure:

- "compliance" with binding regulations;
- "communication" to and with stakeholders;
- "assurance" regarding risk tolerance;
- decision-making, efficacy of the strategy and efficiency of operations.

In this regard, we note that where there is a need for so-called "global" governance models, for example for businesses operating on international markets, the risk management models become more complex.

Table 2.1 The potential value of a business

Potential value of the business	Economic capital value	ROE	Tax planning ROI Leverage
		CAPITAL INVESTED Duration of expected normal average income Capitalization rate	
	Growth opportunities value	Development rate	Internal (dividends policy) External (financial policy) Sales —market shares Purchases
		Duration of competitive edge Profit rate (expected ROE)	

The "global" Governance should extend its competency to the following dimensions (Brawn et al. 2004):

- internal dimension (employees);
- networking dimension (co-makers and partners);
- integration dimension (global market);
- transparency dimension (shareholders and finance);
- corporate ethics dimension (government and media).

Therefore, the purpose of the corporate governance system is not only to support value creation but also to manage stable and durable relationships with the stakeholders. The value levers can be broken down into capital profitability levers and value levers linked to competitive edge, which measures the growth and development opportunities over time (Table 2.1).

A closer look shows the ability to manage such relationships represents a tool, if not an essential condition, for the purpose of gaining a solid reputation and therefore maintaining profitability over time.

As a result, the organization must manage those risks that may impair the value of the business, focusing in particular on the following aspects:

- Long-term perspective: the risk must be managed with long-term strategies and approaches, because competitive edge and value consolidate in the long term;
- systematic risk: risk management will need to integrate the value creation perspectives:
  - "macro" risks: linked to global, EU, domestic and industry-specific factors;
  - "micro" risks: linked to the strategic and tactical choices made by individual businesses.

It should be noted that the measurement of the value of the business is traditionally based on financial, income-related and asset-related methods. The risk analysis is also based on similar methods. Are we really capable of measuring the competitive advantage and its vulnerability by using only these approaches? Managers should always analyze in detail the most appropriate and effective tools.

2.3 Corporate Governance: Regulatory Evolutions

The recent evolutions in the legislative and socio-economic framework have set up a new scenario for risk management. In the various countries, legislators, international bodies, and supervisory bodies have made regulations ever more stringent.

The promulgation of laws and rules that impose on companies stringent obligations relating to governance principles and procedures has stimulated investment growth of businesses through integrated risk management approaches, aimed at ensuring a better control and protecting themselves from the risk of non-compliance. We wish to briefly mention some of the more effective initiatives, albeit bearing in mind that there are many developments under way:

- the Sarbanes–Oxley Act, issued on July 30th, 2002 in the U.S., represents the reform legislation for the corporate governance system of companies listed on the U.S. Stock Exchange for the purpose of protecting investors by improving the accuracy and reliability of corporate information;
- the Combined Code on Corporate Governance, United States, 2003, new version in 2006;
- the Turnbull Guidance, United Kingdom, 1999, and subsequent Smith Guidance and Higgs Guidance;
- Government White Paper, modernizing Company Law, European Commission, 2003;
- Federal Complementary Act to the Swiss Civil Code, "Obligations Code" chapter, 2008.

Significant have been the impacts of the Sarbanes–Oxley Act issued in the United States not so much for the purpose of providing best practice on the governance principles but rather for the purpose of imposing a clear and stringent business liability regime and raise the level of "criminal penalties".[1] It is not by chance that it was issued after the Enron and Worldcom scandals. Still in the United States, similar to the Sarbanes–Oxley Act is the Combined Code on Corporate Governance, published in 2003 and updated as early as in 2006 as a review of the first version published in 1998 by the Financial Reporting Council. The Combined Code does not have the force of law, but it purports to be a codification of the corporate governance principles. Overall, there are 17 of them, from which businesses should draw inspiration.

Unlike in the United States, in other countries, especially the United Kingdom, guidelines on corporate governance have been issued for the purpose of introducing exemplary best practices in order to encourage imitation. The Turnbull Guidance

[1] It is estimated that some 60 % of large US businesses, with a turnover of 20 billion dollars or more, have invested the equivalent of 100,000 man hours (comparable to the full time employment of 70 people for one year) in order to comply with the compliance obligations set, in particular, by Section 404 of the Sarbanes–Oxley Act.

issued by Chartered Accountants in England and Wales and the subsequent Smith Guidance and Higgs Guidance had the initial aim of introducing some guidelines on the implementation of the internal audit section of the Combined Code, and later extending to the areas of corporate governance without ever acquiring the force of law.

Also a Government White Paper, titled “Modernizing Company Law”, was issued by the European Commission in 2003 not for the purpose of defining a single corporate governance code at European level, but rather to introduce a common approach to some essential aspects.

Moreover, in 2008, some amendments were made to the Federal Complementary Act to the Swiss Civil Code, “Obligations Code”, that impose on all companies subject to standard audits the obligation of setting up a formal internal audit system, and, on auditing firms, the obligation of certifying the existence of such a system and taking this into account in their auditing work.

In Italy, for example, the main reference legislation on the subject of controls was introduced from 1997 to 2001:

- Legislative Decree No. 231 of June 8th, 2001, containing “Rules on the administrative liability of corporations”, introduced for the first time, in our legal system, criminal liability of Companies and their directors for certain types of offenses, especially those against the Public Administration;
- Law No. 262/2005, introduced a number of new provisions on the subject of governance of Italian companies. In particular it introduced provisions on the subject of liability and obligations relating to corporate disclosures (similarly to the provisions of Sections 302 and 404 of the U.S. Sarbanes–Oxley Act of 2002);
- Consob Recommendations (Memo of February 20th, 1997) on the subject of corporate control;
- Finance Consolidated Act (Legislative Decree No. 58/1998), which establishes the duties of Statutory Auditors on the subject of supervision and internal audit;
- Code of Conduct of the Italian Stock Exchange;
- Instructions by Bank of Italy regarding the Internal Controls System;
- Legislative Decree No. 231 of June 8th, 2001 (as amended) on the subject of Companies’ Administrative Liability.

In addition to the laws and guidance statements directly linked to the issues of governance, reference can be made to many other areas of legislative applications that affect, to a significant extent, the governance system, for instance:

- directors’ liability;
- business continuity and disaster recovery;
- safety and security;
- environmental regulations.

The Organization for Economic Co-operation and Development (OECD) has provided a definition of the contents of *Corporate Governance*,[2] that highlights, in particular:

- Board of Directors' liability;
- commitment to an effective corporate governance;
- the role of stakeholders and the commitment to the utmost disclosure and transparency;
- fair treatment of shareholders.

Therefore, Corporate Governance extends beyond the area of relationships with shareholders only, based on the *agency theory* or *shareholder value theory*) (Fama et al. 1983), and affects all stakeholders in their capacity as parties responsible for the social legitimization of the company. It should be stressed in no uncertain terms that the significant focus on social legitimization resulting from the many stakeholders represents one of the reasons why today reputational risk management is so important, as we will see in next chapters.

The Sarbanes–Oxley Act entailed the establishment of the Public Company Accounting Oversight Board (PCAOB), with the task of defining the Auditing Standards, by Management, of the internal control system.

The PCAOB Auditing Standard No. 2. para. 14 reads as follows:

> In the United States, the Committee of Sponsoring Organizations (COSO) of the Treadway Commission has published Internal Control–Integrated Framework. Known as the COSO report, it provides a suitable and available framework for purposes of management's assessment.

The COSO Report is therefore the framework better known and accredited for implementing governance.

As we will see later, it is yet to be proven that it represents the best approach to risk management.

Risk management and Internal control should coexist but are not the substitutive. The Internal Control System represents a set of rules, procedures and organizational structures aimed at ensuring:

- compliance with corporate strategies;
- achievement of the effectiveness and efficiency of corporate processes;
- safeguard of the value of the activities and protection from losses;
- reliability and integrity of accounting and management information;
- operational compliance with laws and regulations.

The risk assessment is part of the internal control activities, but does not end there. This means that not all the risk assessment approaches and techniques can be managed and governed by the internal control manager.

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[2] In 1999 the Corporate Governance Principles were approved, on the request of the OECD Council of Ministers (later updated in 2002). The World Bank, the International Regulations Bank and the International Monetary Fund took part in the process as observers.

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http://www.springer.com/978-88-470-2530-1

Risk Management
How to Assess, Transfer and Communicate Critical Risks
Borghesi, A.; Gaudenzi, B.
2013, X, 142 p., Hardcover
ISBN: 978-88-470-2530-1