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Risk Management

## It's all about balance

By Bill Spinard, Craig Faris, Steve Culp and Paul F. Nunes

High performance requires a keen understanding of not only a company's appetite for risk but also its capacity to manage that risk effectively. Companies that walk that fine line between the two can better protect themselves and pursue new marketplace opportunities.

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Traumatized by the global economic meltdown, many companies have chosen to hunker down and play defense. Though understandable, that approach won't light any fires under corporate performance, or fuel a recovery.

On the other hand, some companies appear primed to go on offense with major spending sprees. Hundreds of them are sitting on piles of cash these days, having saved billions in the last year or so by cutting jobs and capital spending. But can they spend that money prudently, bearing in mind the painful risk management lessons of the recent past?

Both situations underscore an underdeveloped capability in the global business community: a keen understanding of not only a company's appetite for risk but also its capacity to manage that risk effectively. Companies that achieve a balance between the two can better protect themselves and pursue new marketplace opportunities.

Application of this expanded concept of "risk-bearing capacity" is something new to the field of risk and performance management for non-financial companies. It is a measure of a company's resiliency and agility—an estimate of its ability to take on new opportunities, as well as the scope and type of economic shocks it can bear without a serious decline in its operational effectiveness.

Using a risk-bearing capacity analysis, companies can balance their appetite for risk taking against their ability to manage those risks. Neither too cautious nor too reckless, they can adjust either their capacity or their appetite to make more prudent—and ultimately successful—investment decisions.

The failure to effectively manage risk—by companies, governments

and households—is at the heart of the current economic crisis. But doubling down on bad bets and taking bigger chances in a desperate bid for much-needed growth is not the solution for business. Nor is the answer to become so cautious as to leave opportunity on the table. This new approach to risk can help companies find the path that is right for them, helping them bring risk appetite and risk capacity into balance.

The capacity to effectively understand and bear risk to support profitable growth involves much more than just sound financial management and the building of capital reserves—as important as those are. It is also more than defensive posturing—sounding the alarm and then circling the wagons.

### **Multidimensional**

Risk-bearing capacity is multidimensional, comprising at least five components: financial strength, management capacity, competitive dynamics, operational flexibility and risk management systems (see "Measuring your risk-bearing capacity," page 5). Effective risk-bearing capacity analysis can help companies establish stronger links between strategy and operational planning, which enables them to optimize capital allocation, identify additional resources available to seize opportunities, craft much more relevant and powerful performance metrics, and achieve better focus on performance reporting.

Risk-bearing capacity also expands the traditional idea of risk management beyond financial resources, focusing a company on a broader picture of operations, management processes, systems, culture and leadership that can increase resiliency in the face of setbacks, and improve agility to pursue new opportunities. That is, it helps a company deal with both the downside and the upside of risk—to play defense as well as offense.

# Risk in the balance

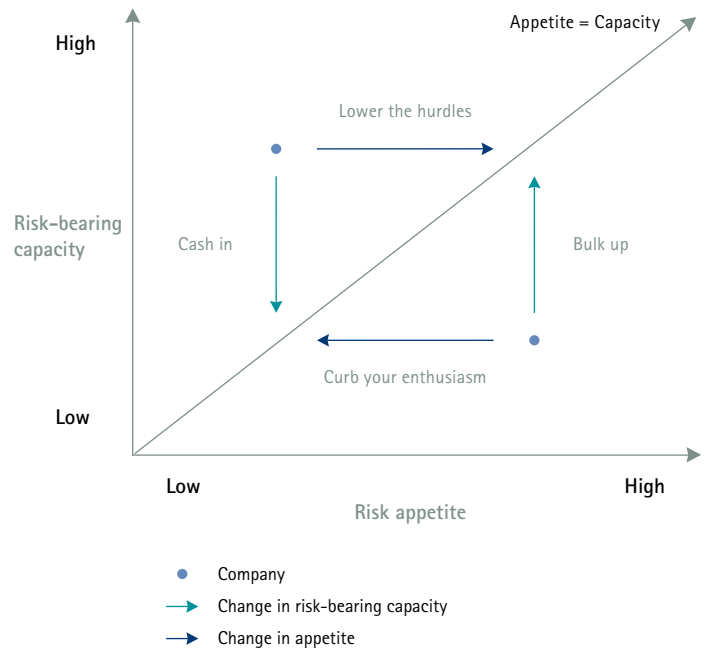
High performance requires a strong appetite for risk, but one that is balanced with an equal capacity for bearing risk. Taking on too much risk eventually leads to trouble, but taking on too little when the company is highly successful can cause underperformance. Companies seeking their very best performance, therefore, need strategies to bring their risk appetite and risk-bearing capacity into balance.

Four risk–balance positions

Risk-bearing capacity	High	<b>Missed opportunity</b> <ul style="list-style-type: none"> <li>Limited ability or willingness to pursue the upside of good risk management</li> <li>Significant chance of underperformance</li> </ul>	<b>On the march</b> <ul style="list-style-type: none"> <li>Big strategic plans with the ability to execute</li> <li>Strong potential for large rewards with reduced uncertainty if well aligned</li> </ul>
	Low	<b>Safe, but maybe sorry</b> <ul style="list-style-type: none"> <li>Small strategic plans with likely ability to execute them</li> <li>Strong chance of underperformance</li> </ul>	<b>Risky business</b> <ul style="list-style-type: none"> <li>Big strategic plans but inadequate capacity to bear risk</li> <li>High potential for overextension or catastrophic event</li> </ul>
		Low	High

Risk appetite

Four strategies for balancing risk-bearing capacity and risk appetite



Source: Accenture analysis

Bad things happen to good companies, but some of those things are more predictable than others. Effective management of risk-bearing capacity enables companies to deal more effectively with two types of adverse events.

First are incidents that occur semi-regularly and have a modest impact on the company, such as input price volatility, labor issues or foreign exchange fluctuations. These events rarely come as a surprise, and most management teams have experience in responding to them. The financial impact of such incidents is generally minimized by adjusting the selling price or the level of reserves such as cash.

Second are the low-probability but high-impact events, including

the loss of a major manufacturing facility, natural disasters or the failure of a major supplier. These events are the ones that nightmares are made of—crises that can stop a company in its tracks, or drive it out of business completely.

### Disaster recovery

Few companies can afford to set aside sufficient capital to protect against these infrequent occurrences; instead, these events are usually mitigated through disaster recovery, insurance and business continuity plans. A high-performance business, however, will excel in managing this kind of adversity. It will have in place the means to work around the event faster than its competitors, along with the resilience to bounce back sooner.

Consider Walmart and its well-acknowledged capacity to stay business-ready during natural disasters better than its competitors. The giant retailer has historically gained market share in the wake of hurricanes or other serious events because of its ability to recover from the momentary shock to its supply chain and reopen rapidly, with stores using mobile generators as needed. There is tremendous opportunity—in goodwill and assistance to the community, to say nothing of increased sales—in being the first, or only, store operating in a blacked-out storm zone.

Companies that create high risk-bearing capacity are able to manage their financial, operational and management resources in a coordinated and integrated fashion to lessen the impact and hasten their recovery from an adverse event. They are also better positioned to recognize and act on new opportunities in the midst of economic or marketplace turmoil.

When risk-bearing and risk-managing capabilities are effectively leveraged, there is considerable potential for gain. To fully exploit risk-bearing capacity, it is important to gain a more dynamic understanding of risk—recognizing opportunity instead of focusing on potential negative impacts. The improved ability to identify growth opportunities is where risk-bearing capacity can help companies leapfrog the competition.

A company doesn't grow without having a certain "risk appetite"—the sum of the amount and type of all risks that it knowingly accepts in the execution of its strategic plan. Included in a company's risk appetite is an explicit acknowledgement that it will be exposed to the infrequent, hard-to-predict, high-impact adverse events just discussed.

The question companies must be able to answer more effectively than they can now with traditional risk analyses is whether that appetite is properly matched with their risk-bearing capacity.

When a company has optimized its portfolio from a risk/return perspective—when all available resources are fully and efficiently employed in value-creating activities and a prudent portion is held in reserve to absorb shocks—its risk-bearing capacity is in balance with its risk appetite.

Indeed, risk appetite and risk-bearing capacity are different sides of the same coin. Risk appetite is the stated willingness to accept exposures to uncertain events; risk-bearing capacity is the available risk-adjusted capabilities to manage this exposure.

### **Fixing misalignments**

Taken together, the concepts provide management with more (and more nuanced) levers—and not just financial ones—to manage the company's exposure to emerging and especially unforeseen events.

As shown in the chart on page 3, the optimal place for a growing company to be is in the upper-right quadrant of the appetite/capacity matrix, with a strong risk appetite aligned with a strong risk-bearing capacity. A challenge many companies unknowingly face today, however, is that these two risk components are not properly balanced. This is true partly because of the downturn and partly because creating and maintaining such a match is a perennial challenge.

While such a mismatch is not uncommon, it is at best unhealthy and at worst threatening to the company's viability. When risk-bearing capacity is greater than risk appetite,

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# Measuring your risk-bearing capacity

Analysis of a company's risk-bearing capacity does not produce a single number or one easy answer. Rather, such analysis looks at the interaction of several dimensions that, acting together, can make a company more resilient and better able to take on appropriate risks.

## Financial strength

This element is the easiest to measure as it can be considered a distillation of established financial measures and ratios such as cash flow at risk and debt equity. Traditional solvency parameters include leverage, credit rating, cash generation capabilities, trading multiple, earnings strength and diversification.

## Management capacity

Managerial capacity is an evaluation of the effectiveness of management processes, and how well they are employed to add value to the shareholder—a kind of blend of credit rating, investment analysis and corporate governance analyses. Management capacity covers the breadth and depth of the management ranks, as well as leadership's experience with executing the strategic plan and in resolving and bouncing back from crises.

## Competitive dynamics

Competitive dynamics refers broadly to a company's position in the marketplace relative to competitors and market trends—past, present and future.

## Operational flexibility

Operational flexibility is the evaluation of a company's ability to react to market trends and developments while still maintaining strategic focus and financial continuity. It includes components such as production line switchability or alternative supply chain sourcing capabilities.

## Risk management systems

Risk management systems include the people, technology, systems and processes that a company employs to identify, measure, mitigate and monitor its risk exposures and that protect its solvency and stability during extreme events. The protective dimension includes disaster recovery, business continuity planning and crisis management planning. The evaluation of risk management systems relative to leading practices provides a view of how effectively a company understands and manages both downside and upside opportunity risk. In the absence of effective risk management systems, the ability to leverage risk-bearing capacity is greatly diminished.

A risk-bearing capacity analysis looks at these five dimensions individually and in interaction with one another to provide both qualitative and quantitative indicators of overall capacity, as well as currently employed and identified reserve capacity.

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companies miss opportunities and leave money on the table. In this case, several underlying causes may be at work. Strong financial performance (driven by either internal or external events) may be providing a high level of capacity, but it is short-circuited by cultural conservatism or poor integration with strategic planning.

Management may be a root cause here. The board or senior leadership may have a high risk aversion due to earlier corporate travails; or they may not adequately understand the financial tools, such as leverage, that are available to exploit resources and seize opportunities.

Alternatively, a strong focus on operational flexibility may be driving an overall increase in risk-bearing capacity but may not be matched by similar growth in risk taking within the company's strategic evaluation and planning processes.

Where the appetite for risk is greater than the risk-bearing capacity,

companies are either strategically overextended or unable to achieve their strategic objectives. In this situation, companies are involved in strategic plays or operational approaches that are unsustainable, which degrades their financial performance. By appearing vulnerable, they set themselves up as potential targets for competitors.

The strategic challenge is how to bring the two measures into balance, especially in an environment of both greater market uncertainty and commensurately greater market opportunities.

Fortunately, there are solutions, depending on what is causing the imbalance (see chart, page 85). For instance, if risk-bearing capacity is low and appetite is high, companies can grow their capacity or shrink their appetite. Or if risk-bearing capacity is high and appetite is low, companies can similarly reverse the course of each. These strategies are not entirely exclusive, as many companies should seek to simultaneously grow both capacity and appetite to reach their full potential.

## Misalignment 1: When your risk appetite is bigger than your risk capacity

When a company's appetite for risk is larger than its capacity to bear that risk, one of two strategies is available to realign appetite and capacity.

### Bulk up

To increase risk-bearing capacity, a company can pursue several options. Hoarding cash is one tried-and-true approach to increasing financial agility and flexibility. Companies as diverse as Alcoa, General Electric Co. and Hewlett-Packard Co. have all been noted in the press recently for their strong cash positions.

And consider Google, whose cash and short-term investments totaled \$22 billion in the third quarter last year—a whopping 58 percent of its total assets, and up 53 percent from the previous year. As Google CEO Eric Schmidt told analysts, the cash provides “operating and strategic flexibility.... We're very happy

to have it sit in our bank account and earn a modest interest rate.”

In fact, cash holdings have grown steadily to meet the increased volatility of the rapidly integrating multi-polar world. Companies are now holding more cash, and a greater percentage of their assets in cash, than at any time in the last 40 years. Between 1989 and 2009, the world’s 500 largest nonfinancial companies more than doubled the cash portion of their assets, from an average of 4.4 percent to 9.8 percent, bringing the total in cash reserves for those companies to nearly \$1 trillion.

However, hoarding cash tends to be a slow approach to growth unless accompanied by a cash enhancer, such as increased process efficiencies or cost reductions. In addition, it is difficult to try to amass cash reserves in a recession. Hoarding cash may also increase the risk of being an acquisition target, so this approach should be accompanied by savvy competitor analysis as well.

A second way to bulk up capacity is to acquire another company expressly for its excess risk-bearing capacity. Although this activity can actually increase post-merger integration challenges and other risks and may therefore seem counterintuitive, the right acquisition can dramatically and

rapidly increase risk-bearing capacity. Since this approach requires significant capacity to accomplish in the first place, it is not for every company, and should be considered a major step in changing risk-bearing capacity, not just an incremental improvement.

Third, driving operational excellence is a good way to increase risk-bearing capacity, by improving financial strength (from improved cash flow in lower operating costs, for example), operational flexibility and competitive dynamics. In addition to increasing risk-bearing capacity, this option can quickly improve a company’s overall performance relative to its competitors.

Fourth, a company can increase its risk-bearing capacity by improving the effectiveness of its risk management systems, which is always a good idea. Better risk management provides capacity increases in several ways. Mitigating risks in the early stages of development saves resources. Additionally, by reducing exposure in some places, the ability to better manage risk can provide capacity that can be employed elsewhere.

Taking it a step further, an increased understanding of how risk actually affects the investment portfolio can improve investment performance and extend capacity for new opportunities.

## Curb your enthusiasm

While increasing risk appetite and capacity are usually the best options for enhancing a business, a second option is in fact to reduce the company’s risk appetite.

Accenture advises companies looking to reduce risk appetite to conduct a serious strategic review, including an evaluation of both the company’s focus and objectives. Companies with outsized appetites for risk often suffer from diffusion of effort (“It

all looks good”), inadequate market/competitor/capabilities analysis, and naïve or overly optimistic attitudes toward decision making.

We suggest a hard evaluation of performance and capabilities as part of a strategic reassessment to redefine how much risk is appropriate. Another related option is to set new target threshold levels so that they either 1) realistically realign appetite to available capacity or 2) increase capacity

through something like a bond rating improvement.

If the goal is increased capacity, then an improved bond rating

provides benefits such as reduced cost of capital and, therefore, increased financial capacity. If the goal is reduced appetite, the realistic realignment should do it.

## Misalignment 2: When your risk-bearing capacity is bigger than your risk appetite

Excessive timidity often characterizes companies whose risk-bearing capacity actually is large enough to bear the additional investments that could launch them faster out of recession. As with the first kind of misalignment of capacity and appetite, companies can deploy two different approaches to achieve realignment.

### Lower the hurdles

When a company's risk-bearing capacity is greater than its appetite, the best strategy may be increasing risk appetite rather than wasting or reducing spare capacity that can be hard to create or come by. One way to increase a company's effective risk appetite is to increase the utilization of production and business capacity.

To do this, corporate leadership increases the authority of select business groups or business lines to provide a "hunting license" for new opportunities—that is, an increase in capital allocation for new investments or acquisitions coupled with a loosening of the criteria or required return demanded for funding new investments.

Companies experiencing excess capacity may find ready opportunities within their key business groups, although these opportunities often go unexplored in an environment that is overly risk averse. To overcome this hesitancy, companies should encourage the right opportunities so that they are brought to the investment table. Increasing the allocation of funds to top-performing units is often an effective way to do that.

A second approach to increasing risk appetite is to revise strategic plans and realign them with medium- and long-term financial projections. Often, companies with excess capacity are operating from an out-of-date playbook; they are still working with strategic plans—ones developed with old capacities—that have never been appropriately modified. Therefore, a strategic realignment may be the solution for updating aspirations and appetite.

Third, companies can quickly change strategy and identify new opportunities by accelerating M&A activity. Targeted acquisitions serve to both employ risk capacity and provide strong platforms for growth. Cisco Systems, a company famous for its ability to make useful serial acquisitions, has recently continued this feat, spending some of its enormous \$35 billion war chest to purchase such companies as Pure Digital Technologies and Starent Networks.

It goes without saying, however, that an acquisition can have a large impact on a company's management, culture and operating model, so intense due diligence is required.

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# Weighing in on risk

How do executives know when their risk-bearing capacity is out of alignment with their risk appetite (see story)?

An appetite for risk that exceeds the capacity to manage it can be spotted in several ways. Some more obvious signs include a rapid increase in scale, perhaps from merger activity; a substantial increase in leverage; or a significant commitment to new markets or new offerings—or both.

Companies with too little capacity also often find themselves realigning performance expectations—that is, they underperform relative to their original investment plan for strategic opportunities, and then regularly adjust the plan downward. Simply listening to the market and your employees can also provide valuable insights. Negative analyst reports or a decline in share price or credit rating without a corresponding decline in current financial performance may indicate the market thinks you are moving too far, too fast. Similarly, unexpected management departures or increases in voluntary turnover may suggest a loss in employee confidence in your strategy.

The signs of being too conservative—having a risk-bearing capacity that can accommodate a bigger appetite—can be more elusive. Playing it safe is so often considered a virtue that failing to take advantage of a reasonably large appetite for risk might be seen instead as wise discretion.

At some point, however, justifiable caution turns into unjustifiable tentativeness. Look for historically high levels of cash not connected with particular market conditions, or a sustained reluctance to spend cash reserves.

Another warning sign is a high hurdle rate for new initiatives. In this situation, management demands to see a high expected return on internal resource allocation before it will approve a new project. This approach often reduces the number of potential opportunities considered, and therefore can also reduce risk exposure to a degree. But a hurdle rate that is significantly above the cost of capital can indicate a strong aversion to risk and an unwillingness to step out into new areas.

Unnecessarily high dividends may also be a sign of an appetite too modest for a company's risk-bearing capacity. The market may signal a risk appetite problem with a decline in share price not related to current earnings and not shared by competitors due to market conditions. Investors may not be confident that the company will pursue market opportunities with vigor. On the people side, if competitors are snatching up top talent, it could be a sign that you've lost your spark and aren't offering your employees enough good opportunities.

## Cash in

Although companies will most often try to employ excess risk-bearing capacity to seek new opportunities, there are other options, as evidenced by the actions of Southwest Airlines Co. In fact, Southwest Airlines is a great example of using well-managed growth to achieve long-term success. By limiting growth for decades to a predetermined annual percentage, the company has avoided the traps of either overextension or underachievement, and has effectively balanced its strategy with its risk-bearing capacity.

For any company looking to effectively reduce its excess risk-bearing capacity to align with risk appetite, the easiest and most effective paths involve some form of liquidation. One type is a direct return of excess capacity to shareholders via increased dividends.

For example, the banking industry has come under pressure from different stakeholders to surrender some of the cushion the banks have built up by selling shares, hoarding cash and increasing profits. Shareholders, looking for their part of the accumulated wealth, are demanding bigger dividends.

Although dividends and liquidation are a great way to reduce capacity, this approach is hard to reverse, so it must be strategically evaluated in that light.

A third way to reduce a company's risk-bearing capacity is to reduce operating capacity—for example, by reducing staff, operational hard assets or processes. While this option, too, is more or less permanent, it can create a short-term transfer of capacity from hard assets and processes to cash, which can then be easily eliminated via dividends.

### For further reading

"Constructive tension," *Outlook*, June 2009

Achieving high returns, and high performance, demands that companies take risks. But real and sustainable high returns come from the expert management of risk. By maintaining a properly balanced risk-bearing capacity—one that neither exceeds nor falls too far below the company's risk appetite—a company can mitigate an earnings decline and emerge from today's economic uncertainty on a higher growth trajectory.

The application of risk-bearing capacity analysis can help companies improve their strategic agility and their ability to be resilient in the face of adverse events. When a company aligns its risk capacity with its risk appetite, it also cuts waste and improves operating efficiency. Equally important, the effective management of risk-bearing capacity can also increase a company's ability to capitalize on new opportunities.

In a world of limited financial resources and uncertain market conditions, it is critical that companies neither overextend nor underutilize their risk-bearing capacity. A company that operates beyond the boundaries of risk capacity can destroy company value and even endanger operations.

But playing it too safe means missing opportunities for growth and profitability.

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