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Modern Risk Management: Managing risk through the ethical business culture model

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Modern Risk Management:
Managing risk through the ethical business culture model

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What does it mean to state that risk management is an expression of an organisation's values? This article discusses the basis for identifying the connection between organisational values through the lens of ethical business culture and attempts to draw out linkages with current risk management thinking. The approach described allows an analytic approach to risk management to be inserted into an ethical assessment method.

Defining the Current State of Risk Management

While risk is nothing new to corporations, there is an increased awareness of it among managers. Arguably, globalisation has contributed to this awareness through exposure to different kinds of risk; e.g. underlying social, economic, and physical environmental changes (climate change, population movements, and economic interconnectivity). So, while it is not certain that corporations operate in a *more* risky environment, there is a clear sense that the overall risk environment is *different and less understandable*. It is this sense of living in a new world that has led to the emergence of numerous risk management guidelines, frameworks, and standards as a means of asserting better control over risk.

This desire to produce a more up-to-date, comprehensive, and integrated approach to risk management has come to be based on the assertion that risk management should "integrate the process for managing risk into the company's overall governance, strategy and planning, management, reporting processes, policies, values and culture."[1] This assertion has, in turn, highlighted the connection between risk and ethics, but also revealed a paradox—that is, early efforts to link risk management to ethics and values have *not* been accompanied by a dearth of ethical lapses, which suggests that there is a need to better understand the connection between risk management and corporate values.

Ethical Business Culture

Business culture, at the fundamental level, is the product of individuals who share a common set of beliefs and of the assumptions within their working environment that direct behaviour. These beliefs and assumptions are manifested within various systems, processes, and interactions that are characterised both formally and informally.[2] *Formal characteristics* of business culture express the quality of its leadership and its ability to manage processes and people through the firm's business and governance structure and policies to effect desired employee behaviour and decision-making processes. *Informal characteristics* of business culture are manifested through a company's expressed values, implied behavioural norms, and role models narrated through a company's myths, rituals, beliefs, and historical stories.[3]

An ethical business culture is grounded on the alignment between formal structures and processes, and informal recognition of heroes, stories, and rituals that inspire organisational members to behave ethically.[4] Within the corporation this implies that business leaders demonstrate personal moral integrity and commitment through their actions. To develop and sustain an ethical business culture, a company must be willing to not only comply with formal legal requirements, but also actively espouse its moral values and demonstrate the alignment of those values with all other elements of the culture. The Center for Ethical Business Cultures (CEBC) identified a model of ethical business culture (MEBC) consisting of five characteristics congruently linked:[5]

1. Values-Driven;
2. Leadership Effectiveness;
3. Stakeholder Balance;
4. Process Integrity; and
5. Long-term Perspective.

It is no accident that the MEBC presents a platform on which corporate conscience is indelibly imprinted. By focusing on the five characteristics of an ethical business culture,

organisations have specific directions to take in building and sustaining their corporate culture based on ethical principles and metrics to measure progress.

It is our premise that ethical business cultures are based on an array of uniquely espoused values. Rather than trying to define a set of universally acceptable risk management values to apply to all companies, it may be more prudent to invest time and resources in understanding how to identify and assess the interplay of corporate values in connections with risk management.

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The MEBC places great emphasis on the distinction between *espoused values* and *values in action*. This distinction gives rise to a 'space' within which many ethical risks may originate. Ken Goodpaster[6] has introduced the concept of teleopathy or "goal sickness." Teleopathy posits the view that an organisation's Values, Goals, and Means stand in precarious balance with one another and that breaks or distortions in the linkages among the three tend to challenge ethical behaviour. However, as CEBC observes, there may be alignment issues that precede the Values, Goals, and Means connection, e.g. the link between espoused values and values in action. A source of risk *internal* to any business may be found in the space between the values a company publicly espouses, and the values embodied within its practices. Analysts might query how the organisation's espoused values translate into or shape the organisation's day-to-day behaviour. For example, if *trust* and *transparency* are stated values, how do those values translate into actual behaviour within the company and between the company and its stakeholders? A declaration of the importance of trust as an organisational value, when placed alongside behaviours that undermine that value, creates an ethical risk for the firm.

Externally, there exists a link between a corporation's espoused values and values held by society at large. Corporate policy and procedure may exhibit internal consistency; however, if they link goals and means to socially reprehensible values, they create a misalignment between the organisation's ethos and that of the broader society. Such misalignments represent another source of ethical risk.[7] Thus, there are two effective venues for the emergence of ethical risks – the difference between internal espoused values and values in action, and the difference between broader societal values and the organisation's values in action.

Values: The Risk Management Perspective

Risk is seen as producing both positive outcomes (via opportunities) and negative outcomes (via hazards). Risk management does not focus only on eliminating or reducing risk, but on finding a proper balance between risk taking and risk mitigation.[10] *Risk management* exists to directly support the fulfilment of organisational (or situational) objectives, and thus is seen as an element of the policy setting, strategy setting, governance dimension of management, and leadership.[11] While top management should establish clear expectations, the general view is that the implementation and practice of MRM is dispersed throughout the entire organisation and embedded in processes and systems. In this context, MRM explores ways to connect itself to organisational culture and organisation values. Why and how has this happened?

A new environment of expectations has emerged over the past 20 years for the practice of risk management. Drivers of these expectations can be found in a wide range of sources: regulator and rating agency interests in corporate resiliency, internal and external audit requirements, citizen expectations for local government responsiveness to community safety issues, and global expectations for meaningful responses to climate change. Ulrich Beck[8] has observed that these rising expectations are linked to many aspects of modern life, including:

1. information systems and the influence of the media;
2. fears arising from new and highly mysterious (at least mysterious to the general public) risks;
3. greater degrees of global interconnectivity; and
4. the intensifying focus on residual risk as science and technology improve quality of life in wide-ranging ways (e.g. controlling infectious diseases, improved public safety).

Many of these expectations also have emerged in response to specific events: sensational cases of corporate fraud and malfeasance, oil spills, volcanoes, terrorism, and financial crises.[9]

Even with the proliferation of guideline/standards documents focused on risk management (e.g. ISO 31000), and various nation-specific frameworks and standards, as Figure 1 suggests, there are many other direct and indirect ways in which risk management has become an expectation (or even a requirement) in addressing specific risk issues – financial regulation, trade rules, and labour practices. These expectations provide a picture of the type of risk management 'expected' – it is holistic, integrated, comprehensive, strategy related, and systematic. The term Enterprise Risk Management (ERM) is often used in reference to this form of risk management. As there are some constraints imposed through the use of the term ERM, the authors suggest a slightly relaxed term and will hereafter refer to this phenomenon as Modern Risk Management (MRM).

MRM is reasonably well framed and fairly well understood among risk specialists. Broadly, organisations are expected to develop an approach to risk management that is attuned to the environmental conditions and the context of an organisation's current situation, including:

1. an understanding of the history of the organisation or situation;

Figure 1.

Corporate Risk Universe

External → **External**

Market
- New competition
- Industry Consolidations
- Socio - political
- Pricing pressures
- Product demand
- Capital availability
- Energy costs
- Materials costs

Regulatory
- Anti-trust
- Communications
- Security
- Trade Customs
- Labor Practices
- Pension
- Product safety
- Health and safety
- Procurement
- Recruiting
- Environment
- Tax

Financial
- Liquidity
- Credit
- Accounting
- Tax
- Market

Compliance
- Governance
- Legal
- Code of conduct

Internal

Operations
- Value Chan
- Sales and Marketing
- People
- Product
- IT

Strategic
- Strategy and initiatives
- Mergers and acquisitions
- Investor relations
- Stakeholders
- Image & reputation

Hazards & 3rd Party Actions
- Natural events & catastrophes
- Terrorism
- War
- Privacy/ counterfeiting
- Fraud
- Lawsuits

2. an evaluation of the external and internal environments;
3. some form of stakeholder assessment; and
4. an evaluation of the organisation's goals, purposes, values, and intentions.

Once the context has been established, MRM involves:

1. Assessing risk;
2. Responding to and treating risks;
3. Evaluating and monitoring risks; and
4. Effectively communicating to stakeholders.

Establishing a 'Values' Context for MRM

It remains unclear if 'ethical risks' represent a distinct category of risks or whether they are an aspect of existing categories. Regardless, understanding how risk management reflects organisational values, it is a useful exercise to think about social, cultural, and organisational values as a source of risk. First, values and culture seem to produce risks that should be identified and managed. Second, the relationship of an organisation's values to broader societal values also can serve as a source of ethical risk. Third, there is no obvious method for organising an understanding of risks that specifically arise from values (and culture).[12]

Adopting a wider perspective, risk is defined as 'variation around expectation.' This establishes two ways that risk relates to business values: (1) expectation is determined by objective observation, but also is influenced by cultural

filters and the implicit values therein, and (2) variation may be mathematically measured, but the meaning of various outcomes is not mathematically determined.[10] What does it mean to a manager to be told that there is a 95% probability a product defect is unlikely to injure customers? Thus, can it be argued that values not only influence the dimensions of risk (expectation and variation), but they define – at least indirectly – the exposure to risk (objectives)? This suggests that any approach to risk assessment would be well served to include a consideration of the ethical aspects of that risk.

Current work by scholars and practitioners in risk management seems to anticipate an eventual link-up with business ethics. However, it does not present easy and obvious ways for this to happen. Similarly, the Ethical Business Culture concept anticipates an inclusion of risk-related perspectives, but does not offer the language necessary to construct a systematic approach to assessing and addressing ethical risks. This presents two specific issues for consideration. First, how is risk management aligned with business values? Second, does the misalignment of values lead to a category of risk called 'ethical risks?'

A Possible Assessment Method

The Veritas Institute has developed a set of assessment and improvement tools that help organisations evaluate whether their management systems and cultures support and sustain their espoused values. These tools enable firms to assess the variation or 'gap' between the values they profess and their values in action, and to take corrective action to close that gap. Use of the Institute's tools also fosters improved clarity about the nature and practical implications of a firm's espoused values. They help leaders form an ethical business culture by aiding values deployment and alignment. That is, the tools help leaders ensure their organisation is both *values-driven* and marked by *process integrity*, that is, the firm's stated values are embedded within the strategies, policies, procedures, and practices that shape how it creates goods or delivers services.

The Institute's tools are based on a method known as the *Self-Assessment and Improvement Process* (SAIP). The SAIP method integrates insights from corporate ethics, spirituality, and total quality management. More specifically, its underpinnings include the principle of moral projection, the practice of conscience examination, and the organisational self-assessment approach used within the Baldrige Performance Excellence Program.

The SAIP method builds on the parallel between the person and the organisation by extending to the latter the practice of conscience examination, a discipline employed by individuals for centuries to aid their moral and spiritual development. The SAIP creates an organisational analog to the frameworks that individuals frequently use for this examination, i.e., a structured series of questions. Following the Baldrige approach, the SAIP translates a set of ethical principles into a systematic inventory of questions

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concerning an organisation's management system, that is, the operating policies, processes, and practices that shape how it performs its work. By answering the questions within the inventory on the basis of evidence – for example, strategic and operating plans, process documentation, program descriptions, and metrics that capture vital outcomes achieved – and then scoring these responses using a set of evaluation guidelines, a firm can determine the degree to which it has integrated vital moral aspirations within its operations. The resulting assessment highlights strengths and deficiencies, and allows leaders to launch improvement initiatives designed to more deeply and comprehensively embed moral principles within their firm's management system.[13]

The SAIP method is flexible, and can be used with different sets of ethical principles. Regardless of the specific principles employed, all SAIP-based assessment tools foster an enhanced awareness of the ethical concerns confronting an organisation. Their questions highlight actual and potential misalignments between how it *operates* and the moral values or principles it *professes*, between what an organisation *does* and what it *says*. They permit an organisation to examine its management system critically, with an eye toward discovering whether the decisions and actions that system prompts are congruent with its moral aspirations.

Assessment tools based on the SAIP method arguably place risk management at the service of a firm's moral commitments. By enabling leaders and managers to discern how their organisation's processes and practices may be in tension with its values, they create the possibility of systematically identifying value-specific risks, and of initiating corrective action to mitigate risks through improved alignment between moral aspirations and action. Since these tools are intended to be applied periodically and not simply as a one-time event, they help establish the management of ethical risk as an ongoing discipline within a firm. They foster a risk management mentality in relation to both espoused values (i.e. the risks to which specific values may give rise) and inconsistencies between espoused values and values in action (e.g. risks arising from misalignments between these two values sets).

Concluding Comment

The approach described above provides a way for a risk analytic approach to be inserted into an ethical assessment exercise and to extend the scope of analysis by focusing on what might provisionally be called 'ethical risks.' Consideration of measures that might be taken to treat those risks also becomes part of the analysis. The CEBC model of ethical business culture and the Veritas Institute's methodology provide a basis for articulating the values that should inform a company's risk management (Modern Risk Management) efforts. Those values, the arraying of those values, and the relative importance of those values will differ from company to company. Nevertheless, the articulation of values in light of the MEBC concept should provide direction to an effort (i.e. ISO 31000-inspired) to structure risk management in alignment with the corporation's espoused values. **EBR**

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