Introduction

*Qui ne risque rien n’a rien (Nothing ventured, nothing gained)*

Companies are in the business of earning returns for shareholders as a result of taking risks, and we expect there to be a relationship between the two. Why put capital at significant risk for a return that is no higher than the return on government bonds? Or expect higher than average returns from low-risk activities? It is impossible to separate measuring the performance of a company from the risks that the management takes to achieve it.

Investors can reasonably expect greater rewards for specific risks, such as investing in start-ups or in parts of the world subject to civil war, than investing in more established and stable companies, in safe industries or in settled environments. Nonetheless, risk rarely figures when company performance is described. Financial measures are almost invariably given ("Our profits rose by 15 per cent", "The company earned 23 per cent on invested capital") without any risk context, even when comparisons are made or in any accompanying commentary. While average return is acceptable for an average risk, however, it is not for a highly risky venture. Without defining the context of risk, judgements about performance will be incomplete.

In most aspects of company operations, risk assessment plays a different, but equally important, role. It is an integral part of informed decision taking in achieving performance. Risk assessment is involved from the highest level in strategic choices about what activities to undertake, what assets to buy or what markets to serve all the way to detailed operational decisions about whether to accept payment in foreign currencies and the adequacy of safety measures in the workplace. It plays a part whether or not an organization is aware of managing risk, and many managers feel
that their instinct and judgement are enough – a behaviour risk. The danger is that this leaves company risk unplanned and unmanaged.

Managers are not always helped by those who form opinions. *Good to Great* (Collins, 2001), arguably the most influential management book of the first few years of the twenty-first century, does not even have the word “risk” in its index.

The evidence about what actually happens inside organizations is patchy. The financial services industry is, essentially, about managing different types of risk and has highly developed techniques for doing so, with regulators on hand to ensure that these are in place. Indeed, it is normal in large financial services companies to have a separate risk function. In part these mechanisms and the activities of regulators reflect past problems, including (in recent years) the bankruptcy of Barings Bank through derivatives losses, $2.6 billion lost by a Sumitomo copper trader and $0.7 billion lost by Allied Irish Bank in foreign exchange positions. It should be said that, while such losses are dramatic but infrequent, less publicized systemic failures in risk management can be as profound and far-reaching.

Other than in the financial services industry, the nature of the company’s activities and its size are probably the key determinants of whether there is systematic management of risk. At one end of the sophistication spectrum are probably the risk models of large energy multinationals, although large companies in many other industries are developing more advanced models following the requirement for listed companies in some countries to demonstrate effective controls, including control of risk.

The most stringent requirements on risk disclosure are those for listed companies in the United States by the Securities and Exchange Commission. In practice, many of the disclosures are anodyne or designed to cover every conceivable eventuality and thus avoid legal problems, but there is also a great deal of interesting information in the choice of risks disclosed, as well as the content of the statements. These are given in the box 12.1.

In the United Kingdom the control around risk is represented by the need for listed companies to explain if they don’t meet the “Turnbull” requirements as part of the Combined Code (FRC, 2003). More significantly, the Operating and Financial Review – currently best practice but at one stage a potential requirement for listed companies – requires “a description of the principal risks and uncertainties facing the company” (ASB, 2005, 26).
Box 12.1: The influence of SEC risk disclosure requirements

The requirements apply to non-US companies listed in the United States as well as to US companies. Two European examples follow.

- Nokia is listed in the United States and, following the format in its filing, has two pages in its annual report listing risks, including markets, technology, manufacturing, suppliers, products, employees, macroeconomic factors, financing, health and safety and regulation.
- Phillips has no fewer than four pages in its annual report covering risks, including its overall approach to risk, market factors (focusing on China), competitive factors, strategic alliances, technology, business partners, personnel, financing, product liability, supply chain, legal aspects and pension fund matters.

Many of the comments above are based on evidence from larger firms. By contrast, very little evidence is available about how risk is managed for small and medium-sized enterprises (SMEs), though there is highly visible circumstantial evidence of widespread failure to manage risk through a high attrition rate, particularly of start-ups.

Those that manage to survive have, by implication, been at least risk-aware, since it is very difficult to continue to exist as an SME over an extended period without such an awareness. There may be formal risk management only in such areas as checking the creditworthiness of new clients or ensuring that health and safety requirements are met. Otherwise, the approach to risk management is likely to be simply an aversion to loss, precisely because of the sense of vulnerability surrounding SMEs.

Why is risk management not more firmly on the management agenda for many companies, large or small? Some possible reasons might be as follows.

- Risk management has developed relatively recently, so managers are not aware of it.
- Organizations do not have incentives for managers to take account of risk on a systematic basis.
- It is too complex for an older generation of senior managers to understand.
- Those outside financial services regard it as being to do with complex financial instruments, with nothing to offer them.
- Both quantitative and qualitative techniques are dismissed as being of dubious value and inferior to the personal judgements, based on personal experience, that managers feel they bring to bear.
- Risk management is actually taking place, but is not formally recognized as a process.

All these reasons are worrying, because essential elements of risk management are awareness of and communication about the balance of risk. Even
those who feel that they can do better than what they see as flawed or redundant models need to be open-minded about what a more systematic approach might offer.

Those in larger companies may not have much choice. The formal requirements for listed companies, together with pressure from audit committees and the non-executive directors, are pushing the risk agenda into the organization. The professionalization of risk management is providing additional impetus to do so.

In making the links between performance and risk, it's important to remember that, while pressures and techniques are part of the universal world of business, approaches to dealing with the pressures and applying the techniques vary greatly between business cultures (Schneider and Barsoux, 2003). To give just one example, the extreme consequences of risk taking for performance – great wealth or bankruptcy – are more acceptable in the United States than in many European countries.

One of the differentiators here is the role of “face” (Earley and Ang, 2003, 39); generally, there is less risk appetite in countries where the social disgrace associated with failure is seen as a severe sanction. Triandis (2002) notes the greater importance of face in collectivist cultures (e.g. Japan and South Korea) compared to those that are individualist (e.g. Australia and the United States). Approaches also vary between industries. One would expect a different attitude in the mining industry from accountancy, and individual organizations vary from the gung-ho to the risk-phobic.

The sections below deal with these perspectives of links between risk and performance. Section 1 deals with risk in assessing overall company performance while section 2 sets out internal risk management to improve performance. In one aspect of company operations, however, performance and risk are linked rather differently. This is in the way performance is linked to individual reward through any performance-related scheme. Such schemes have to link incentives with amounts at risk for the individual. Section 3, therefore, discusses the links between risk and reward for individuals.

Risk in each case is taken as “any unintended or unexpected outcome of a decision or course of action” (Ansell and Wharton, 1992) or, more succinctly, “any deviation from expectations”. Figure 12.1 illustrates the relationship between the three areas.

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1 Correspondence between author and Zeger Degraeve.
Risk in assessing overall company performance

The directors recognise that creating shareholder value is the reward for taking and accepting risk. (Tesco Annual Report)\(^2\)

One of the weaknesses of traditional performance measures, such as return on investment, whether profit-based (e.g. return on assets) or cash-related (e.g. "free" cash flow), is that they don't take account of risk. Performance comparisons are all too often made as if the organizations take equal amounts of risk. However, this is obviously absurd. Baghdad is a riskier place to do business than Bangalore and high-yield junk bonds are riskier than US government stock.

It might be thought that at least comparisons with others in the same industry might be made without reference to risk. In other words, comparing return on capital employed for the oil majors, or profit growth for pharmaceutical companies, implicitly takes into account that those in an industry bear similar risk. In practice, though, there will rarely be a close comparison, since in most industries the mix of businesses varies greatly between large companies. Even when the industries are not diversified by type of business, there is greater or less exposure to certain kinds of risk, whether it be to sources of supply in the case of oil, or the type of medical problem on which research is focused in the case of pharmaceuticals.

Comparing profit or cash flow with companies in dissimilar industries or at different stages of development is of particularly doubtful value in

\(^2\) All references to Annual Reports are to 2005 issues, covering 2004. In each case, a full and updated report is available on the company website.
measuring company performance, unless relative risk is taken into account. To compensate for higher risk, in general a start-up has to do better than an established player and a biotechnology company has to earn higher returns than a water utility.

One way to take account of risk is to incorporate it in an appropriate performance measure, such as through calculating the risk-adjusted return on capital. The use of one of the economic profit models that compares returns with the cost of capital will enable risk to be reflected in the cost of capital used. In such models, accounting profits are adjusted to give financial returns that will provide the appropriate signals for current decision taking and for measuring long-term cash returns. These returns are then compared to the weighted average cost of capital, the risk factor being incorporated in the cost of equity (see Martín and Petty, 2000, for different types of adjustment and Arnold, 2005, 93–105, or Ogier, Rugman and Spicer, 2004, for a full description of the methodology). Box 12.2 gives an example.

Box 12.2: Economic profit at Michelin

Michelin provides not only an economic profit figure each year but a comparison with the target. In the five years to 2004 the actual return varied from 6.5 per cent to 8.5 per cent. The target varied from 9.8 per cent to 11.4 per cent – a rare example of detailed disclosure. The commentary gives a division of the capital employed into “economic capital” and debt. It also gives the cost, which in this period varied around 16 per cent for economic capital, while the cost of debt fell from around 7 per cent in 2000 to less than 5 per cent in 2004. The notes to the table in the Annual Report explain the basis of these figures.

Source: Annual Report.

There are different economic profit models, including economic value added, cash value added, cash flow return on investment, free cash flow and others. These are marketed by specialist consultants, each with a different approach to making adjustments to the profit figure to get a return that is nearer to cash and less affected by accounting policies.

The results, by whatever method is chosen, can then link to decision taking inside the organization, as set out in the section below. These results should make clear the methodology and be accompanied by a commentary to ensure that the assumptions are clear and the numbers are put in perspective.

For investors in quoted companies, risk can be taken into account by comparing total shareholder return (TSR) – capital growth plus dividends – to the risk-adjusted rate of return, using the company’s β, which indicates,
based on past performance, the sensitivity of a company’s return to the return on the market portfolio. The calculation is to add the risk-free rate of return (based on government bonds) to the equity risk premium (the expected return in excess of the risk-free rate), multiplying the latter by the company’s $\beta$.

To illustrate what this means in practice, at the time of writing the approximate $\beta$ for Cadbury Schweppes was 0.5, the value for Whitbread 1.0 and that for Reuters 1.5 (Risk Measurement Service, 2005). These figures indicated that Whitbread’s shares tend to move in line with the market, Cadbury Schweppes’ move much less and Reuters’ much more. In investment terms, Cadbury Schweppes would be regarded as a defensive share, Reuters a relatively risky one. Taking assumptions of a risk-free rate of 5 per cent and an equity premium of 5 per cent, we would compare the TSR of Cadbury Schweppes to 7.5 per cent, Whitbread’s to 10 per cent and Reuters’ to 12.5 per cent. In practice, there are further complexities attached to the calculation (set out in corporate finance texts, such as Brealey, Myers and Marcus, 2004), but these do not affect the basic principle behind the calculation.

The Sharpe ratio, which compares return with the volatility of return, is also commonly used for financial portfolio evaluation, though it can be applied more widely. It is used to allow the comparison of a risk-adjusted return with different types of assets over time. The higher the ratio the better the return in relation to the level of risk relative to volatility (see box 12.3 for an example).

**Box 12.3: The Sharpe ratio**

The Swedish holding company Investor AB publishes its Sharpe ratio data. Over a ten-year period to the end of 2004 it was 0.26. For 2004 itself the ratio was 1.2, much higher, and therefore more favourable."

Source: Annual Report.

The measures above provide investors with the means to construct portfolios of quoted companies based on a desired balance of risk using mathematical relationships. For quoted companies, information related to the stock market may also be of use to investors in assessing risk, although there is also a great deal of “noise” from other factors that affect share prices, meaning that the information can only be indicative. For example, a dividend yield that is well above the sector average may indicate greater risk, because the company’s share price is vulnerable or that the dividend is at risk. Another is the forward price/earnings ratio.
A ratio that is very high or very low compared to the sector implicitly reflects an assessment of the relationship between risk and reward. A third possible signal is the balance of analyst buy/hold/sell recommendations and the accompanying commentary. To illustrate what these measures mean for real companies, at the time of writing BP had coverage of thirty-three analysts and a buy/hold/sell balance of 15/15/3, while Shell had coverage of twenty analysts and a balance of 5/10/5. (Note that the balance is not always tilted towards buying: Invensys, an engineering company, had a balance of 1/5/6.)

As far as P/E ratios are concerned, the average of shares traded on the New York Stock Exchange was around 20. Google, however, was trading at a ratio of 75. Holders of Google were, at this price, implicitly taking an equally clear view of risk and reward in buying seventy-five years of last year's earnings compared to those buying twenty years of the market average. (Evidently, the analysts thought so, since the buy/hold/sell balance was 25/8/1.) So, indeed, were holders of Baidu.com, the “Chinese Google”, which at one time traded at a P/E ratio of more than 2,000. These ratios (including Baidu.com) are neither cheap nor expensive. Rather, they implicitly reflect a different set of assumptions about risk and future reward.

Dividend yields and forward P/E ratios relative to the sector and the buy/hold/sell balance can only be indications, being affected by so many other factors. Thus, BP’s better rating by analysts, manifest both in comments and a higher P/E ratio, for example, is an implicit indication of confidence in BP’s ability to handle risks relative to Shell, other things being equal. However, it may also be to due to many other factors, certainly in the short term.

The degree of imprecision will, of course, be greater for unquoted companies, since the absence of a market price makes comparisons more complex and takes away the means to provide a company’s β (Feldman, 2005, 69–89). Risk will therefore be assessed more subjectively — one of the reasons for the discount attached to unquoted companies. Even a notional P/E ratio based on comparisons to the quoted sector can be interpreted only in light of an assessment of risk.

By contrast, lenders have very well-established measures on default risk based on models using historical trends. The major rating agencies, as well as financial institutions, provide continuous and closely watched risk criteria. Standard and Poor’s, for example, provides carefully graded opinions for different types of obligation. The three top grades (AAA, AA, BBB)
range from "the highest" to "adequate" and the four low ones (BB, CCC, CC, C) from "ongoing uncertainties" to "highly vulnerable"; the lowest (D) is already in default. Each rating may be qualified by a "+" or "−". Ratings are given for different countries and evaluate outlook as well as the current position.\(^3\)

The risk of insolvency is covered by a variety of models. One that has been available since the 1960s is the "Z score", which brings together sets of financial variables to give a mathematical probability of default. There are many others (see Edwards, 2001).

The variety of techniques outlined in this section suggests that risk assessment should be part of every assessment of company performance. Limitations of the techniques indicate that they should be used with caution, not that they should be ignored.

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**Internal risk management and performance**

There are areas of the group’s business where it is necessary to take risks to achieve a satisfactory return for shareholders, such as investment in R and D and in acquiring new products or businesses. In these cases it is the group’s objective to apply its expertise in the prudent management rather than elimination of risk. (GlaxoSmithKline Annual Report)

What are the areas in which risk management is relevant to performance? They include the following.

1. Identifying vulnerabilities and opportunities in strategy and budgeting, including capital budgeting, in light of risk appetite, using such techniques as Monte Carlo simulation to create a risk profile.

2. Assessing the possibilities of cost and time overruns in managing projects, again bearing in mind risk appetite, using both formal probability and β analysis as well as more subjective methods (Arnold, 2005, 11–51).

3. Incorporating risk in target setting and performance measures; for example, incorporating key risk indicators as part of a balanced scorecard (say, missed training days in an insurance company as a leading indicator of potential mis-selling).

\(^3\) See “Standard and Poor’s rating definitions” at standardandpoors.com.
(4) Systematically managing operational risk at all levels through good management practices as well as special techniques such as the use of real options (Risk Books, 2003) to adjust operating decisions in response to uncertainty.

(5) Varying the risk factor in relation to specific projects in the WACC used, rather than using a single WACC for all projects.

(6) Identifying risk probability (the likelihood that a particular outcome will occur) and impact (the effect a particular outcome will have if it does occur) in continuing operations, for example using "heat charts" to show the relationship between the two. Figure 12.2 gives an illustration.

Managing these risks is a core differentiator in the quality of management. Bad managers are bad because they allow a company to accept risks without being aware that they are doing so. Skill here includes a systematic approach, communicating that approach and a willingness to review risk appetite in the light of changing circumstances.

As already noted, risk management has traditionally been seen as the province of the financial sector and some very large companies in sectors with high levels of perceived risk. It is usually framed in terms of financial instruments, and, indeed, the spectacular growth of parts of investment banking has been based on developing ever more sophisticated financial instruments to deal with risk.

Since their operations are all about managing the risk of their borrowing and lending portfolios, it is certainly the case that the performance of companies in the financial sector is closely linked to their success in risk
management. Even before being reinforced in recent years by external requirements, particularly from the Basel Committee on Banking Supervision, there were more established techniques, including the use of value at risk, or VaR (see box 12.4), than for other kinds of companies.

Box 12.4: Value at risk

- A key measure of risk, especially in financial service companies.
- "The maximum loss over a target horizon such that there is a low, prespecified probability that the actual loss will be larger" (Jorion, 2005, 253).
- Normally expressed as a monetary amount, given a confidence level and a period of time. For example, the average total daily VaR at Barclays Capital in 2004 (Annual Report, 62–3) was £34.3 million at a confidence level of 98 per cent. Daily losses over this level are therefore likely to occur, on average, twice in every 100 days. This total was the result of aggregating daily VaR for five types of risk.
- Basel rules require a specific calculation of risk (over ten trading days at 99 per cent confidence levels) for all banks, with additional safeguards against failure.
- Caution is needed in using and interpreting the figures.
- VaR does not cover worst loss, or the distribution of losses in the "left tail", and stress testing is therefore required.
- VaR is not a substitute for overall good risk management (Culp, Miller and Neves, 1999).
- Variations of the same principle are included in such measures as "cash flow at risk" and "earnings at risk".

By contrast, the techniques for managing risk in other sectors are far less developed, for many of the reasons set out in the previous section. Managers may claim to be taking account of risks anyway. Their confidence will be misplaced, however, if they recognize only what’s most easily identifiable and quantifiable, and their decisions will be skewed unless they balance the downside with the upside. Contrast the sustained success of the US company General Electric in managing risk through profitable growth in the latter part of the twentieth century with its British namesake (later Marconi) over the same period. The latter was first weakened by twenty years of failing to take enough risk then almost brought down by excessive financial and strategic risk taking in the four years to 2001.
Risk affects all aspects of a company’s operations. Companies are most aware of the implications in the price at which they can raise finance. However, it also affects their reputation (“Are they trustworthy?”), ability to sell (“Will they still be around if anything goes wrong with the product?”), ability to buy (“Will they pay?”) and ability to hire and pay staff (“How secure is my job?”).

The board’s skill in identifying what risks they are prepared to accept to achieve the company’s objectives – risk appetite – and then in managing that risk appetite is fundamental to a company’s strategy. Contrast the implicit risk appetite behind two sets of management thinkers: the “big hairy audacious goals” of Collins and Porras (1996) and the “fast second” approach of Markides and Geroski (2005), who suggest that rewards can be reaped by allowing others to take the risks first.

Companies often associate risk management with avoiding problems, particularly running out of cash. What’s relevant to performance, though, is the skill in managing the risk, not avoiding it. As the example of GEC in the United Kingdom showed, there can be serious consequences from taking an over-conservative attitude to risk, which can give competitors as great an advantage as if a reckless attitude is taken. These consequences come about from circumstances as varied as failing to grasp strategic opportunities, failing to hire good enough people or keeping excess capital.

“Managing” here means choosing between eliminating, tolerating, minimizing, diversifying, hedging, transferring or insuring risks (Degraeve, 2004, 48). Many techniques, such as insurance, are very familiar (and very long-standing; as Kay has pointed out (2003, 232–3). *The Merchant of Venice* would have been a very different play if marine insurance had been available to Antonio). Others, such as hedging, become familiar at times of significant swings in currencies or raw material prices. Some, such as ways of transferring risk, are sometimes less familiar, since they can appear in complex technical products, such as credit risk derivatives.

The areas to be managed range from managing foreign exchange exposure to the use of risk-adjusted discount rates for investment. They include the management of long-term contracts, which could expose the firm to significant losses, whether as supplier or customer. They extend to choosing a pension scheme, when there is a risk to the company of having to make good a deficit.

An illustration of how wide-ranging the definition of the areas to be covered and the actions to cover them can be is given in box 12.5 for
Land Securities plc, a major UK property company. Note that the word “mitigation” rather than “management” is used.

Box 12.5: Risk mitigation at Land Securities

The company identifies twelve types of risk and the ways in which it seeks to deal with them. Among the “mitigation activities” are:

- internal and external research (for market risk);
- key performance measures (for asset management risk);
- compliance procedures and participation in industry organizations (for regulation risk);
- monitoring and the use of financial limits (for development risk);
- an active HR policy (for human resources risk);
- back-up plans (for IT risk); and
- relationship management programmes (for stakeholder relationship risks).

Source: Annual Report.

In identifying risks to be managed, the conventional categorization into strategic, financial and operational is a useful starting point, but it is wise not to get hung up on classification. For a start, the scope and definition of terms differs; legal risk is sometimes identified separately, sometimes as part of operational or financial risk. A second reason is that risks may be related to each other, as when unhedged raw material price fluctuations affect operations. Finally, risks may change, as when a collection of small operational risks becomes strategic.

The key to success of risk management as a whole – for medium-size and smaller enterprises as much as for international companies – is to embed it into day-to-day operations and line management. For example, overall company targets must be set as part of the corporate strategy and in annual budgeting to reflect risk appetite.

As already noted above, one of the ways in which companies can embed risk in decision taking is through the calculation of economic profit. Box 12.6 has an example of the principles, though with some simplifying assumptions. By incorporating the cost of capital adjusted for risk, techniques such as EVA® provide a link to shareholder value as well as a clear basis for choosing between alternatives. Nonetheless, the use of such techniques remains limited, and many companies prefer to rely on less formal methods.
Box 12.6: Economic profit

1. Economic profit = adjusted post-tax earnings less capital x weighted average cost of capital; here take $50 post-tax earnings – $200 capital x 8 per cent WACC (see 2) = $34.

2. WACC includes a cost of debt and equity; here take $200 capital as being 50 per cent debt x 6 per cent cost of debt net of tax relief and 50 per cent equity x 10 per cent cost of equity (see 3) = 8 per cent WACC.

3. Cost of equity derived from risk-free rate + market risk premium xβ; here take risk-free rate as 5.5 per cent, market risk premium as 3 per cent and β as 1.5 = 10 per cent.

Improvement through greater formality does not necessarily mean more numbers. The assessment will be best through a combination of numbers and commentary to put them in context. Indeed, there is a particular danger of relying on a single risk measure, since each has limitations, as shown with value at risk, in the same way that profit or cash flow cannot be relied on as single performance measures.

How can a judgement be made about how well an organization has managed risk? Making sure that processes are in place – risk reporting on which action is taken, risk awareness surveys giving satisfactory results compared to others, etc. – is a starting point.

While the right processes are essential, the key measure of success has to be the outcome achieved by those processes. This does not mean only the frequency and severity of losses, since if the frequency and severity of losses are less than anticipated it could be that the opportunities lost have been omitted and the cost of prevention could have been excessive.

The more balanced way to make the assessment is to look both at what has gone wrong and what has gone right to see whether the opportunities taken and the frequency and severity of any losses or problems correspond to the risk appetite identified. If the frequency and impact of opportunities taken and losses suffered are much greater or less than planned, it provides at least some evidence that risk has not been well managed. Realistically, this will be more of a qualitative than a numerical assessment, not least because of the difficulties of fixing a baseline number and of choosing the time period over which to make the assessment.

In making the assessment, risk culture – the success of the company in communicating risk appetite, linking it to incentives and ensuring that it is
understood and used – needs to be taken into account. Having techniques in place is a necessary condition to demonstrate that risk is being managed but not a sufficient condition for risk management to be successful, since it depends on how the techniques are applied.

**Risk and individual reward**

Incentives should align the interests of executives and shareholders and reward the creation of long-term value within a framework which enables risk to be assessed and managed (one of ICI’s principles for remunerating executive directors). (ICI Annual Report)

The third area in which risk and performance are linked is in relation to performance-related reward. The risk element applies both to companies and to the individuals who work in them.

For companies, the risks are an element in well-established issues of principal–agent relationships. These are “general to virtually all cooperative activity among individuals” (Jensen, 2000, 137), the shareholders as principals taking a risk in the use of employees as agents. Incentives within employment contracts are designed to help align interests, including the different appetite for risk of shareholders and employees.

For individuals, the incentive element designed to encourage them to deliver better performance for the shareholders puts their future income at risk. With an implicit assumption that they are risk-averse, employees need to be compensated by a risk premium for the uncertainty attached to their future income. Individuals’ risk is exacerbated if there are “inefficient” contracts – those that do not balance the cost of risk bearing against incentive gains. The performance element in contracts may also be affected by difficulties in defining outcomes and disparities in information about them, giving rise to two phenomena much discussed by economists, for example in Milgrom and Roberts (1992): adverse selection (taking advantage of information disparities) and moral hazard (when actions are not freely observable).

Many schemes seek to align the risks and rewards of employees and shareholders, of which issuing share options to senior executives is the most prominent. In significant respects, however, the relationship between risk and reward for the two groups is very different. Shareholders bear far less risk (Norris, 2005). Not only can they diversify their portfolios but they can also sell their shares, though only with constraints if the shares are not
publicly quoted. Employees will tend to be less tolerant of risk, being unable
to diversify their own employment risk in the same way as shareholders and
being vulnerable to individual projects going wrong (Rappaport, 1998).
Leaving employment is also a far bigger personal risk than when a share-
holder sells shares. Incentive schemes covering groups carry their own risks,
notably a further distance between individual effort and reward, including
the danger of carrying “free riders”.

Most public attention in this field is focused on executive reward in large,
quoted companies. High headline payouts, especially when profits fall,
inevitably give rise to accusations of payments for failure, with the message
that risk and reward have not been linked – as in the stinging attack on
current practices by Bebchuk and Fried (2004).

Managing the risk–reward relationship and providing clarity about
incentives and performance is at the heart of remuneration committees’
(RemCos’) role. They must be seen to address these issues in setting up
schemes – in economic terms, setting an efficient contract balancing risks
against incentive gains. However, there are plenty of banana skins for
RemCos (Likierman, 2006).

One is failing to identify the risk conditions. This becomes a significant
issue when, as in the late 1990s, huge share price gains give rise to executive
payouts linked only to apparent market over-exuberance. The areas of dis-
satisfaction have included targets being set too low, the incentive amounts
being set too high and the link to performance being too tenuous.

Another is approving schemes in which the downside for the individual
relative to the risk taken is less than the upside. This issue has attracted a
great deal of attention, particularly in relation to share options in the
United States and the United Kingdom. An example is offering options
simply to align shareholders’ interests with those of senior executives rather
than as any kind of incentive. Another is repricing options after share prices
fall, giving executives an apparently one-way bet. The use of share options
has decreased following changes to their tax and accounting treatment, but
the problem can exist with other forms of incentive scheme (Rich, 1999).

These issues are long-standing, but they have become far more prominent
as the focus on good corporate governance over the last fifteen years has
increased disclosure, and therefore the potential for reputational damage to
the company. The problem of reputation is much less for companies that
are not publicly quoted, but linking individual reward and performance in
such companies is often no less contentious internally. Hiring remuneration
consultants has therefore been seen as a way not only to improve schemes
but also to limit external reputational risk and internal discontent by being seen to be in line with others.

Other issues, such as the way targets are set, apply at all levels. An ability to balance risks and rewards in a way seen to be fair is the basis of any good incentive scheme, and they have become more sophisticated in response to pressure (see, for example, Chingos, 2002, for a guide to the factors involved). All the same, widespread and continuing doubts about such schemes and the assumptions that underpin them (see, for example, chapter 21) show that this is a difficult area for the HR departments of companies to get right.

Conclusions

In the book What Management Is, Magretta (2002, 173) comments that “without innovation and risk taking, there would be no economic progress. The discipline of management helps to increase the odds that the risky business of innovation will pay off.” It is effectively impossible to disentangle risk from management, or to argue that risk should not be taken into account in performance assessment and in decision taking.

This chapter has shown three perspectives of the relationship between risk and performance.

1. Company performance comparisons must incorporate a risk element, if possible in the measure used and in any case in the commentary.
2. Risk management must be integrated into the business, including performance measurement, not treated as an optional extra. Risk management does not mean avoiding risks but it does mean accepting that not all risks can be quantified.
3. Risk must be treated as an essential element in performance-related reward. Some investors and many more managers believe that systematic risk assessment is superfluous. They believe that experience and instinct will see them through. It’s a high-risk assumption.

References


