



CLASS: Five elements of corporate governance to manage strategic risk

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Abstract Strategic risk management is an increasing concern for both boards and senior executives. Many recent business failures are due to senior level misjudgement and mismanagement of risk, the consequences of which can range from embarrassment to serious setback to bankruptcy. Ineffective risk management puts otherwise strong business models in jeopardy. Here we present CLASS (Culture, Leadership, Alignment, Systems, and Structure), an integrated, five-element model of corporate governance. We identify how attending to the elements in this framework supports development of an integrated and robust approach to corporate risk, and helps senior executives anticipate and handle the complexities of risk inherent in meeting strategic objectives.

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1. Risk management: A need for a new look

Boards of directors are increasingly willing to take firm managerial action to mitigate the downside risks of strategic change. In February of 2005, for example, the directors of Hewlett Packard suddenly removed Carly Fiorina as CEO because of her management of the risks and slow progress of the complex HP-Compaq merger. Recent pro-

secutions and executive turnover at numerous well-known corporations (e.g., AIG, Marsh and McLennan, Bank of America, Citigroup, Parmalat, WorldCom, Enron, Nortel, and Lucent) also demonstrate growing intolerance of strategic miscalculations by regulators and investors. Sir Philip Watts, chairman of Royal Dutch/Shell, was forced to resign in March 2004 when overstatements of the company's oil reserves and poor results in oil exploration generated a public scandal. As well, Maurice Greenberg stepped down in March 2005 as CEO of insurer AIG, following investigations into bid-rigging and fraud in the insurance industry.

A different view of the practice of risk management needs to be taken. Numerous changes,

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including those that occur as a result of rapidly changing technology, developments in the global business environment, the spate of recent investigations and prosecutions, and the pressure for reform in corporate governance, demonstrate risk management is more complex today than ever before. In the era of the Internet, stakeholder activism is more powerful and widespread. The number of environmental and social activists and non-governmental organizations (NGOs) has increased significantly in the last decade. Professors [Hart and Sharma \(2004, p. 2\)](#) describe how, in ways impossible a decade ago, “smart mobs” are now able to communicate and coordinate their activities using websites, email, and mobile communications. Moreover, they illustrate the ways in which these smart mobs have precipitated strategic change at firms such as Monsanto, Shell, and Unilever.

Inattention and poor strategic risk management can quickly erode competitive advantage. As illustrated by the increasing number of strategic blunders on the part of major corporations, improved decision-making processes have become more and more urgent. Professor [Nutt \(2004\)](#) investigated the causes of two public relations disasters: Shell’s plan to dispose of the Brent Spar oil platform, and Quaker’s costly and unwise takeover of Snapple products. Describing how these firms mismanaged strategic risks by limiting their search for options, making premature decisions, and misallocating time and money, Professor Nutt demonstrates how the context for strategic decision-making has become ever more challenging in the face of complex stakeholder influences and a host of environmental uncertainties.

Adding to these challenges is the spate of regulatory reforms. In the United States, the Sarbanes–Oxley Act of 2002 has increased board and senior executive responsibilities for risk, and forced a more top-down approach to corporate governance. The Turnbull report and future regulatory review will encourage similar rigor and transparency in the United Kingdom. The European Commission also plans to strengthen governance by requiring stronger corporate controls on financial practices, reporting, and risk management.

However, strategic risk management is not limited solely to making necessary improvements in corporate governance and ethics. It includes managing risks that threaten a firm’s long-term competitive success and survival: risks to its market position, critical resources, and ability to innovate and grow. In response to the increasing number and types of risks today’s firms face, leading corpora-

Inset 1

Enterprise risk management and strategic risk management

Enterprise risk management (ERM) refers to a broad approach to risk management that includes strategic risk management. Most recently it has captured attention as the focus of a report by the influential Committee of Sponsoring Organizations of the Treadway Commission (COSO). This committee developed the COSO I framework, accepted in 2003 by the SEC as a best practice guideline for Section 404 of the Sarbanes–Oxley Act (SOX 404), which relates to reporting of internal controls. COSO I was expanded beyond reporting of internal controls to enterprise risk management in the COSO II framework of 2004. It will likely be widely discussed and implemented in future years.

ERM is described by the Treadway Commission as encompassing all business risks and opportunities, in contrast to risk management by department or function:

“Enterprise risk management is a process, effected by an entity’s board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives”.¹

In its new, integrated enterprise risk management framework, COSO envisions ERM as a continuous process that is overseen by senior executives and boards, and as the responsibility of everyone in the organization. COSO identifies components of ERM and makes a direct relationship between these and organizational objectives, including strategy, operations, reporting, and compliance. As described by [Levinsohn and Williams \(2004\)](#), the COSO II framework is a very broad one that includes both strategic risk management and corporate governance.

tions such as GE, Wal-Mart, Bank of America, and IBM have begun to adopt enterprise-wide approaches to risk management (described in [Inset 1](#)).

¹ Source: Retrieved March 7, 2005, from http://www.coso.org/Publications/ERM/COSO_ERM_ExecutiveSummary.pdf.

2. CLASS: The five elements, strategic risk management, and corporate governance

We believe effective risk management must be defined broadly in order to avoid strategic failures. We identify five integrated elements that underpin a firm's ability to manage risks, engage in effective corporate governance, and implement new regulatory changes: Culture, Leadership, Alignment, Systems, and Structure. Referred to, for the sake of convenience, by the acronym CLASS, each element relates to the others. For example, organizational culture is shaped by leadership practices. Systems support organizational structure and shape its culture. Alignment ensures each element is harmonized with the others so that, for example, explicit cultural norms are reinforced by leadership, and systems reinforce the culture. No one element stands alone.

Boards and senior executives can review each CLASS element to build and fortify risk management and governance capabilities. As Fig. 1 illustrates, each element positively reinforces the others and strengthens strategic risk management. After engaging in an examination process, board members can map organizational challenges against these elements, identify areas in need of improvement, and plan change management programs. Superior risk management programs and stronger firm governance capabilities result.

2.1. Element 1: Culture

In October 2004, Marsh and McLennan was sued by New York attorney-general Eliot Spitzer for

rigging bids on insurance contracts and accepting special contingent commissions. As a result, CEO Jeffrey Greenberg was ousted, the firm was forced to reach an \$850 million settlement, and the loss of revenue from special commissions forced drastic job cuts and share price declines. Cultural problems were an important root cause of these woes. Not only was Marsh and McLennan known for its arrogance and secrecy, CEO Greenberg set high financial targets for his managers which, if not met, could lead to dismissal. This cultural intolerance of failure resulted in some managers engaging in excessive risk-taking, rule-bending, and gaming the system.

Citigroup has also suffered setbacks many attribute to cultural deficiencies. In September 2004, Japan's Financial Services Agency (FSA) terminated Citigroup's private banking operations in that country after investigations into alleged improprieties. This decision cost Citigroup \$244 million in the fourth quarter of 2004 alone, denied the bank access to wealthy Japanese customers, and temporarily shut it out of Japanese government bond auctions. FSA investigators faulted a culture where profits were chased at any cost.

In several other high-profile examples, cultures that maintain an attitude of arrogance, encourage secrecy, and/or create an unwillingness to admit failure have spawned disastrous consequences. As Schein (1996) notes, culture is one of the most powerful influences on organizational decision-making and strategy. It can be a vital aid to strategic risk management and a source of competitive advantage; however, culture can also contribute to destructive behaviors. Aspects of



Figure 1 CLASS: Culture, Leadership, Alignment, Systems, Structure. Five elements of corporate governance to manage strategic risk.

culture that can work against good governance and risk management include:

- Unethical behavior;
- Excessive internal rivalry;
- Intolerance of failure;
- Propensity for risk-taking;
- Secretiveness; and
- Persecution of people who speak up (“whistle-blowers”).

As Fig. 1 illustrates, culture is intricately linked with leadership, alignment, systems, and organizational structure. Professor Schein’s (1996) research demonstrates that the founder’s personality can both create and shape organizational culture. The author observes that culture is influenced by historical events and can be reinforced by systems, particularly when management can manipulate incentive systems to reinforce specific behaviors. Significantly, he believes managers need to understand the power of culture in organizations to influence values and behaviors. Other researchers have upheld the validity of Schein’s work. For example, Professors Baucus and Near (1991) developed and tested a model of illegal behavior in organizations. Studying Fortune 500 corporations over a ten-year period, they identified 141 violations that resulted in convictions in 88 firms; in fact, some firms had multiple convictions. The authors’ findings and analysis provide empirical evidence that a past history of corruption inclines firms to repeat such behavior. They comment (p. 31):

“A corporation’s culture can predispose its members to behave illegally. As the relationship between prior violations and illegal behavior appears to indicate, some firms have a culture that reinforces illegal activity. Firms may also socialize employees to engage in illegal acts as a part of their normal job duties.”

Additional studies reinforce the impact of culture on ethical behavior and illustrate the interrelatedness of culture and organizational systems. For example, Professors Castellano and Lightle (2005) describe three specific cultural concerns in cases of fraud they have studied:

- (1) The degree to which preoccupation with meeting analysts’ expectations permeates the organizational climate;
- (2) The degree of fear and pressure associated with meeting goals; and
- (3) Incentive plans that encourage unethical behavior.

These values and systems appear to create cultures that reinforce illegal activity.

Interestingly, Professors Morrison and Milliken (2000) investigated the related issue of “organizational silence”, which they describe as “the widespread withholding of information about potential problems or issues by employees” (p. 706). They identified factors conducive to silence, including managers’ fear of negative feedback and a set of implicit beliefs often held by managers that speaking up about problems is inappropriate or futile. These findings are consistent with the work of Castellano and Lightle (2005).

Such research clearly reveals a need to be concerned with culture’s influence on employee behavior. Effective cultures (such as those found at Costco, Johnson and Johnson, and Starbucks) align well with business needs, yet support development of risk management and governance competencies. They are dedicated to openness, transparency, high ethical standards, and fair competition, while at the same time meeting customer and stakeholder commitments.

Professor Simons (1999) underscores the importance of culture as a “belief system” that enhances traditional control systems used to manage risk in organizations (p. 93). In his scheme, this belief system communicates core values and mission, and helps resolve uncertainty of organizational purpose. As he notes, culture cannot easily be separated from leadership (Simons, 1995): it is shaped and supported by systems, both those that reward desired behavior and those that punish undesired activities. The reciprocal reinforcement of each of the five CLASS elements is critical for effective, ethical strategic risk management.

An ethical and effective corporate culture encourages integrity and openness, and balances those elements with reasonable levels of risk-taking. Table 1 presents questions that can be used to probe whether firm culture supports good corporate governance and strategic risk management.

Table 1 Element 1: Culture

- (1) Are the company beliefs and values openly articulated in mission statements, and do these include ethical concerns?
- (2) Does the culture temper a drive for entrepreneurship and success with a tolerance for occasional failure?
- (3) Do employees feel free to bring problems to executives without fear of adverse consequences?
- (4) Is the organization unduly concerned with meeting short-term earnings targets, and are fear and extreme pressure associated with missing numerical goals?
- (5) Do incentive plans in any way encourage or condone unacceptable, unethical, and illegal behaviors?

Academics have identified a number of ways management can ensure a healthy organizational culture. For example, Professor [Schein \(1996\)](#) recommends building organizational learning capacity to increase awareness of how culture shapes organizational effectiveness, and proposes use of process consulting and coaching skills to achieve this goal. Professors [Castellano and Lightle \(2005\)](#) recommend formal cultural audits to assess the tone of an organization and define improvements. They propose boards of directors engage outside firms to conduct cultural audits every three years, and that external auditors formally include assessment of the tone at the top in their evaluations of internal controls. In cultures that condone secrecy, Professors [Morrison and Milliken \(2000\)](#) suggest top management change is a necessary but insufficient precondition for breaking the climate of silence. They also note time and effort are required to overcome employee resistance to speaking up, since change throughout the organization (including creating appropriate systems to reinforce the desired cultural norms) is required.

We suggest boards can address critical cultural weaknesses in a number of ways, including:

- Implementing new and stronger controls;
- Restructuring incentive systems;
- Educating employees;
- Creating communication programs; and
- Providing individual and team coaching.

Furthermore, it is critical to remember organizational culture cannot be separated from national culture, and global firms should take into account national cultural differences in designing risk control systems ([Hamilton & Kashlak, 1999](#)).

2.2. Element 2: Leadership

Naveen Jain, former CEO of Internet firm InfoSpace, was charismatic, visionary, and passionate, attracting both employees and investors to the firm. At the height of the dot-com boom, InfoSpace was worth \$31 billion; however, Jain and other executives have been accused of misreporting revenues and using fraudulent schemes to create an illusion of success. He has also been portrayed as a reckless, ruthless, and bullying leader. And although Carly Fiorina brought magnetism and enormous sales and marketing skills to her role as CEO of Hewlett Packard, she was also accused of egotism and self-promotion at the expense of company interests, as well as insensitivity to the organization's engineering culture. As the new CEO of Procter and Gamble in 1999, Durk Jager

attempted rapid change to kick-start innovation, but his abrasive style alienated firm managers. As a result, P and G experienced a major decline.

Professor [Conger \(1990, 1999\)](#) describes "the dark side of leadership" (1990, p. 10) and how the skills and personality traits that serve leaders well in rising to the top may also lead to their undoing. Charismatic leaders are often admired for their vision; however, the greater a leader's commitment to a vision, the less willing they may be to entertain competing viewpoints. This single-mindedness can lead to unrealistic aspirations and inappropriate strategies. Professor [Kets de Vries \(1993\)](#) reinforces this concern when discussing the psychology of leadership. His studies suggest leaders and followers can exhibit irrational behavior and distorted thinking in making strategic decisions. [Khurana \(2002\)](#) proposes that leadership irrationality can further extend to the boards and recruitment professionals who guide the process of appointing CEOs.

It is tempting to blame organizational failures solely on top management, but leadership requires committed and consenting followers. Research by [DeCelles and Pfarrer \(2004\)](#) suggests when the "dark side" of charismatic leadership is combined with stakeholder pressure for results, the risks of corporate corruption are increased (p. 11). [Conger \(1990, p. 49\)](#) describes how followers may tend to become dependent on a visionary leader, idealize that leader, and ignore their negative qualities. They may become "yes people" and carry out orders without question, even when these orders fly in the face of logic and business realities. Problems of "group think" can occur, and leaders may even acquire a sense of omnipotence as a result of the uncritical support and blind obedience of their followers.

Do charismatic leaders get results? Professors [Tosi, Misangyi, Fanelli, Waldman, and Yammarino \(2004\)](#) studied 59 CEOs from a sample of Fortune 500 companies over a ten-year period (1988 to 1997) to see whether charismatic leadership is associated with improved firm performance. Leaders were identified as charismatic by other executives in each company. Interestingly, results showed that CEO charisma seemed to be related more to CEO compensation packages and stock prices than to broader indicators of firm performance. The study demonstrates that charisma, while attractive, does not generate positive results on its own.

A charismatic leader does, however, possess at least one advantage. As Professors [Flynn and Staw \(2004\)](#) found in their ten year study (1985–1994) of 44 CEOs from 46 Fortune 500 firms, charismatic

leadership can influence external support for the organization. In particular, it makes the company more attractive to outside investors. The research confirmed charismatic leadership is associated with enhanced stock prices, notably in difficult economic conditions. The authors conducted experiments to show that, when faced with appeals from a charismatic leader, managers may become less risk averse and investors may be enticed to make additional investments in company stock.

Research suggests a charismatic leadership style can positively affect certain measures of company performance. Such leadership, though, does not alleviate the current crisis of ethics and risk management in many firms; in fact, it may actually encourage such crises. Professor Sankar (2003) suggests more attention be paid to a leader's character, in particular to moral literacy, and to core values such as integrity, trust, truthfulness, and respect for human dignity. In his view, leadership excellence is based more on character than charisma. Sankar's work reinforces the importance of leadership on organizational culture, and ensuring the alignment of culture with leadership.

Table 2 poses a number of cautionary questions to assess the governance and risk management abilities of leaders, and identify areas for improvement. Again, these questions demonstrate the interrelated nature of the five elements of CLASS, encouraging boards to take a holistic view toward risk management and the alignment of critical elements that affect a firm's risk management profile.

Boards of governors can improve leadership and its effects on governance and risk management in a variety of ways, including:

- Making formal appointments to roles such as chief risk officer;

- Centralizing key risk management activities in a corporate department;
- Planning a balance of competencies and experience in executive teams; and
- Developing and coaching executives.

In making such appointments, the board can counterbalance the role of a charismatic leader with the thoughtfulness of a chief risk officer, develop systems that reward longer-term strategic and ethical systems, and reinforce a healthy culture. Boards can also concentrate on selecting leaders who demonstrate what Greenleaf (1977) termed a "servant-leadership" style (p. 262), which focuses on the role of leader in the individual development of followers. It ensures leadership evolves throughout the organization and is shared among management, rather than centralized in one individual.

Boards can also guard against unethical leadership by employing seven mechanisms. Professors Grojean, Resick, Dickson, and Smith (2004) found to build an ethical climate in organizations. These mechanisms include:

- (1) Using values-based leadership;
- (2) Setting an example;
- (3) Establishing clear expectations of ethical conduct;
- (4) Providing feedback, coaching, and support regarding ethical behavior;
- (5) Recognizing and rewarding behaviors that support organizational values;
- (6) Being aware of individual differences among subordinates; and
- (7) Establishing leadership training and mentoring.

Leaders and the board members who appoint them can improve standards of governance and the practice of risk management. Appropriate leadership styles are critically important for developing values, ethical character in followers, culture, and organization-building.

2.3. Element 3: Alignment

After a series of disasters in the early 2000s, a much smaller and weakened Marconi PLC is all that is left of famed U.K. conglomerate GEC. Founded in 1889, GEC achieved international success as a manufacturer of electrical and lighting equipment. Later, it diversified into other businesses, including defense and telecommunications, and was regarded as a national champion. Under Lord Arnold Weinstock, the company was tightly managed, profitable, and successful for many years. By 1996, however, GEC

Table 2 Element 2: Leadership

- (1) Is the leadership considered charismatic and possessing extraordinary powers?
- (2) Does the leadership show an absence of reflection and unrealistically assess opportunities and constraints in the business environment?
- (3) Are leaders committed to developing the highest standards of corporate governance, managerial judgement, and independence of mind in their followers?
- (4) Does the leadership show sensitivity to the needs of all important organizational stakeholders (internal and external)?
- (5) Does the board ensure leaders are measured and motivated not only by stock valuations, but also by longer-term strategic and ethical considerations?

had fallen out of favor with the City of London because of a belief that its corporate governance had become old-fashioned; in fact, some thought the company was not delivering sufficient shareholder value due to outdated governance. Others speculated that GEC's large cash reserve was an unexploited opportunity.

Under George Simpson, a new management team proceeded to dismantle GEC's portfolio of businesses to focus on high growth telecommunications. Unfortunately, Simpson and his chief financial officer, John Mayo, made serious misjudgements in strategy and took increased risks in competitive arenas. For example, they paid 4.1 billion pounds to acquire U.S. firms Fore and Reltec at the peak of the telecommunications boom in 2001. Not only did they overpay for these firms, but the deals were made in cash, when competitors (such as Cisco) reduced the risk of similar acquisitions by paying with their own stock. In the wake of the ensuing disaster, over 30 billion pounds of shareholder value was destroyed and thousands of jobs were lost. In May 2005, due to an inability to compete with foreign rivals, Marconi failed to win any part of a much sought-after 10 billion pound contract with U.K. telecommunications giant BT (British Telecom). GEC's failure has been attributed in large part to egregious failings in corporate governance, strategic risk management, and financial reporting systems.

Disasters such as GEC's are usually systemic in nature and reveal not only individual mismanagement, but also inability to align key functions and their responsibilities in the face of rapidly changing environments. Professor George Labovitz (2005, 1997) defines alignment as an optimal state in which people, key processes, and strategies work in tandem. Alignment is a key element that, if neglected, can lead to severe coordination, performance, and financial problems. Professor Labovitz's investigations reveal organizations achieving this state outperform their competitors in every financial measure.

The U.S. Sarbanes-Oxley Act (SOX) and other regulatory changes require firms to improve alignment between governance, financial reporting, and risk management; for example, the board must assess the effectiveness of the audit committee as part of compliance. The audit function now plays a higher profile role in risk management. In a global survey of 1400 executives by Price Waterhouse Coopers (2004), firms making enterprise risk management a priority believed that higher prioritization of the audit function increased their ability to take appropriate risks to

create value. These executives also found it easier to document and leverage internal controls in line with SOX.

Alignment is not easy to achieve. Many organizations struggle to manage interfaces between external and internal audit, regulatory compliance, and risk management functions. The challenges of creating internal alignment of systems that support appropriate levels of risk-taking include the development of a common language, and understanding among employees as to the nature and tasks of governance and risk management. Proper alignment also requires conflicts between functions be addressed. Unnecessary overlaps of jobs and areas of accountability, as well as gaps in responsibility, must be identified and resolved. This may require complex and difficult organizational change.

Business scholars have conducted limited research into the business performance impacts of aligning governance, risk management, and reporting systems. However, a study by Professors Baker and Gompers (2003) of over 1000 venture-capital financed firms indicated board composition and venture capital involvement in governance were associated with lower rates of firm failure. They discovered venture-backed boards were about 10% less likely to be liquidated or delisted than boards that were not venture-backed. This data suggests venture capital involvement in board composition results in stronger risk management.

Nonetheless, other research into the impact of commonly suggested mechanisms for aligning governance, reporting, and risk management is inconclusive. For instance, Turley and Zaman (2004) examined a number of studies on the corporate governance effects of audit committees on financial reporting quality and corporate performance. They found no evidence of an automatic relationship between the adoption of audit committee structures or characteristics and the achievement of particular governance and control effects. This data indicate that we do not yet know how best to ensure systems which are aligned internally to support appropriate risk management.

The inconclusive nature of present research clearly indicates a need for further investigation regarding best practices in alignment. In support of this recommendation, in April 2005 the Financial Times Group launched a new set of corporate governance indices to track the performance of firms and provide better information to investors. Data from this initiative and future research may provide further evidence of the benefits of improved alignment between risk management, governance, and reporting systems.

There are many important aspects of alignment between enterprise risk management, strategic management, and governance. Misalignment can arise from rapid organizational change, failure of firm governance, and lack of adoption of a strategic perspective on decision-making and risk. There may be a misalignment of risk-return trade-offs throughout the firm, as some are easier to identify and deal with than others; thus, these receive the most management attention. Corporate and business strategies need to be well aligned with a firm's risk management capability and its proclivity for risk. Professor Labovitz (2005, 1997) also emphasizes the critical role leadership plays in effective organizational alignment; leadership styles need to be aligned with culture, systems, structure, and accepted approaches to risk.

The questions in Table 3 can help boards judge whether the organizational alignment of capabilities is conducive to stronger risk management and governance.

Alignment can be improved in a variety of ways. We suggest:

- Ensuring strategy-making processes align performance objectives with risk propensity and regulatory demands on the firm;
- Aligning organizational changes and structural redesign with regulatory compliance and desired ethical standards of behavior;
- Designing new information and knowledge management systems to support enterprise risk management;
- Creating new senior management integrating roles; and
- Training and developing managers to raise awareness about risk and compliance issues throughout the organization.

Table 3 Element 3: Alignment

- (1) Do the company's recent actions and performance show evidence of unfocused and misaligned priorities?
- (2) Do the board, senior executives, and top management teams collectively have an understanding of the best practices in corporate governance, risk management, and internal reporting, and how these may be aligned?
- (3) Have the responsibilities of senior executives and governance, audit, and risk management committees been properly aligned to ensure compliance with regulations such as Sarbanes–Oxley?
- (4) Is there regular communication between internal auditors, external auditors, and senior executives concerned with risk management?
- (5) Do strategic planning and risk management processes encourage an appropriate balance of conservatism with entrepreneurship, and risk avoidance with opportunity seeking?

2.4. Element 4: Systems

Italian dairy conglomerate Parmalat collapsed in December 2003 after defaulting on its debts and the discovery that accounts had been falsified on a huge scale to cover up business losses. The company was some \$15 billion more in debt than reported, one of the largest frauds in business history. Parmalat's failure demonstrates lack of strong financial control systems can lead to disaster on a grand scale. According to Roberts, Swanson, and Dinneen (2004), there were widespread failings in Parmalat's basic controls, involving items as fundamental as cash accounting. The offenses were myriad: one powerful group of managers and owners fraudulently overstated earnings for more than a decade, sales were inflated and numerous expenses and losses were unaccounted for, cash on hand was misstated by billions of Euros, and the company was forced to acknowledge that a \$5 billion account with Bank of America was fictitious. Through shell companies, Parmalat had managed to conceal debt for years and to report it as being retired when it was not.

Deficient internal control systems and accounting irregularities also led to disaster at Lucent. In December 2000, the company announced an internal audit had identified irregularities and that previously reported revenues had been misstated. The company recorded a downward adjustment to fourth quarter 2000 revenues of \$679 million in its financial statements. As a result, investors launched numerous class action suits against the company and the SEC commenced investigation. Lucent failed to cooperate with the SEC as charges were made against it for a \$1.5 billion accounting fraud. In the end, ten top officials were found to be involved in fraudulent accounting, the company was fined \$25 million, and it suffered severe loss of reputation.

The Lucent scandal and uncovering of numerous similar abuses in U.S. companies led to the Sarbanes–Oxley Act of 2002. For many firms, compliance with the Act means major reforms in corporate governance and financial reporting. Section 404 introduces stricter rules, requiring management to report on the effectiveness of internal controls over financial reporting. According to Professor Verschoor (2005), the cost of implementing Section 404 can exceed \$35 million in the first year, with continued expenses in future years. In his view, the Act has had unintended negative consequences and is overly complex.

Despite the administrative and financial burdens of SOX, Professor Farrell (2004) suggests

companies should treat compliance as an opportunity to introduce an enterprise-wide approach to risk management, including financial, legal, and operational aspects that affect an organization's strategic goals. He suggests companies use SOX 404 rules as levers to help achieve enterprise-wide transformation of business processes. Improvements that may result from this transformation include greater use of automation, streamlining, increased uniformity in controls, and greater responsibility by process owners. Interestingly, Professor Farrell also describes an enhanced and vital role for internal auditors in linking internal control reporting with risk management to achieve the overall aims of the organization.

Damianides (2005) also suggests organizations use Sarbanes–Oxley as the impetus for reviewing governance and increasing the effectiveness of controls over information technology. He believes strong IT governance helps organizations ensure operational continuity, and especially promotes managing IT strategically for competitive advantage. The author describes the crucial role IT can play in monitoring the effectiveness of internal controls over financial accounting, and in establishing a sound internal control environment. To achieve these advantages, many companies will need to improve communication between IT management and internal and external auditors. Damianides proposes organizations implement the Co-biT (Control objectives for Information and related Technology) governance framework developed by the IT Governance Institute. As well, he also suggests the use of strategy maps, as described by Kaplan and Norton (2004), to ensure better alignment of IT with business strategy.

As Professor Simons (1995) notes, corporations need not view control systems as necessary evils; rather, corporations should use them for strategic benefit and to support the organization's future development. He describes how management can use control systems in interactive ways to focus organizational energy and learning toward innovation and growth. Simons notes how other systems, not just those concerned with IT and financial reporting, can put firms at significant risk of failure and of not achieving desired goals. He suggests a broader view of risk control systems that includes, for example, strategic planning and reputation management.

We previously identified the critical, reinforcing role systems play in terms of shaping behavior and affecting culture. Sound control systems provide the board with necessary information to determine whether the organization is managing risk appro-

priately. They also demonstrate what values the organization is promoting and how those values are translated into action. To ensure control systems play their important reinforcing role in risk management, the board can use the questions listed in Table 4 to review the existing systems and their contribution to control, reporting, and overall risk management. This list should be expanded in the context of individual firms.

The variety and complexity of systems can be so great that many firms will be challenged to find the time and resources to implement all necessary improvements in governance and risk management. Farrell (2004, p. 12) admits that applying strategic risk management has significant costs, but may be even more expensive to neglect. Investments include:

- Establishing a risk framework and common risk vocabulary;
- Establishing and maintaining a chief risk officer or risk committee;
- Measuring and monitoring continuously; and
- Updating the risk assessment framework periodically.

Improving the management of risk requires firms to consider the adequacy of formal systems to identify, analyze, forecast, and manage a wide range of business and strategic risks. As noted earlier, however, there is significant interplay among the elements of CLASS. For example, we propose the role of chief risk officer to guard against unethical leadership, but the same role also helps create strong organizational systems to comply with SOX and mitigate system-induced risk. Additionally, as Professors Hamilton and Kashlak (1999) suggest, global firms need to take into account national cultural differences in designing control systems for risk. Such control systems should form part of a global strategy.

Table 4 Element 4: Systems

- (1) Does the company have an effective and standardized system of internal controls and financial reporting?
- (2) Does the company regularly assess changes in the business and regulatory environments that have an effect on internal control systems?
- (3) Is the organization attempting to link implementation of SOX 404 with initiatives to improve strategic risk management?
- (4) What systems are currently in place to identify, assess, and mitigate risks across the organization?
- (5) Is the organization attempting to implement a framework and systems for IT governance that will be acceptable under SOX 404?

2.5. Element 5: Structure

Consider the saga of AIG (American International Group). Long-standing CEO and chairman Maurice “Hank” Greenberg dominated the successful insurance giant, whose board included nine AIG executives. Greenberg and other insider board members also ran private companies closely linked to AIG, including Star International, which provided substantial extra compensation to senior AIG executives. Former MCI CEO Bernie Ebbers took care to cultivate and reward an inner circle of board members for their loyalty, with perks ranging from rotating chairmanships to favors worth millions of dollars, such as renting company aircraft at minimal cost. At the same time, Ebbers made extensive use of company loans to support his own affairs and closed his eyes to conflicts of interest among board members.

The potential for abuse of power and need for independent thinking have led many reformers to oppose combining the roles of CEO and chairman, and having large numbers of insiders on boards. For example, a study by [Uzun, Szewczyk, and Varma \(2004\)](#) examines the impact of board composition on the incidence of major corporate fraud in the U.S. from 1978 to 2001. They found a significant correlation between the composition of boards and the structure of board oversight committees with the incidence of corporate fraud. Alternatively, as the number of independent outside directors on a board and in the board’s audit and compensation committees increased, the likelihood of corporate wrongdoing decreased.

Counter-arguments can be made for the benefits of having a combined CEO/chairman role and a preponderance of insider board members. Such members may hold important company-specific knowledge and be strongly committed to the company’s affairs; as well, a combined CEO/chairman may be uniquely positioned and empowered to champion corporate strategies. Professors [Dalton, Daily, Johnson, and Ellstrand \(1999\)](#) analyzed 27 separate research studies between 1972 and 1999 on the relationships between board size, membership, and financial performance. This team concluded that while there appeared to be a relationship between board size and performance, the causes for that relationship and the effects of board composition were less than clear. Research in other national settings also reveals an inconclusive relationship between board composition and performance. For example, research into Malaysian companies in the period 1994 to 1996 by [Abdullah \(2004\)](#) found that neither board independence nor leadership

structure showed any relationship with firm performance.

While research evidence may be inconclusive at this point, most agree that in the present climate of reform, boards need to consider how they can structure themselves (and the committees that report to them and the organization) to support good governance and risk management. There is a clear need to promote independence of thought within boards to avoid conflicts of interest. As we have seen from previously cited examples (e.g., Parmalat, Lucent, et al.), a common pattern in many of the most egregious recent corporate scandals is the abuse of power at the top of firms. Some authorities suggest an antidote to this may be a greater degree of decentralization and the adoption of a more participative and democratic management approach within the organization. For example, Professor [Collins \(1997\)](#) makes a compelling argument that participatory management systems are ethically superior to autocratic structures. To ensure the requisite culture to support the design emerges, such a structure requires careful review of the organization’s leadership and systems.

Compliance with Sarbanes–Oxley Section 404 requires managers to look broadly at the organization’s structure. They need to be aware of the relationship between structure and systems of internal controls. [Farrell \(2004\)](#) makes the case that, rather than responsibility for internal controls being delegated to an organization’s financial group, responsibility for evaluation of risk and controls should be done by those most directly involved in each process of daily operation. Such a distributed evaluation is consistent with the enterprise risk management approach, which considers the need to manage risk at all levels and across the organization. [Farrell \(2004\)](#) also suggests the role of internal auditor may become more prominent as the need for internal knowledge-sharing and communication of effective risk management practice becomes more urgent. The auditor may become an educator and promoter of best practices within the organization.

Making structural changes to comply with the need for governance reform and to support risk management is a challenge even for well-run firms. Implementing a structure requires identifying appropriate systems to ensure communication across the organization, and creating systems that enable the structure to function. Structure affects culture by reinforcing individual organizational roles. Alignment of appropriate structure with cultural norms, leadership, and systems strengthens a firm’s risk management abilities. [Table 5](#) lists key questions for boards to consider.

Table 5 Element 5: Structure

- (1) Are the roles of chairman and CEO combined? If so, how are any conflicts of interest managed?
- (2) Is there an appropriate degree of diversity, and are outsiders on the board?
- (3) Does the organizational structure provide an effective system of checks and balances for governance and strategic decision-making?
- (4) Are there strong roles for internal auditors and risk managers, with an appropriate structure of reporting to senior executives and board committees?
- (5) Is the responsibility for assessment of internal controls structured throughout the organization?

Key issues for boards are:

- Understanding the changing nature of risk organizations face as they grow and evolve;
- Understanding how major structural transformations lead to changes in strategic risk exposure; and
- Designing improved strategic risk management practices into structural change programs.

3. Fitting a firm's risk management strategy to the situation

In developing a risk management philosophy, senior executives should consider the business environment, the stage of their firm's growth, and their position in the industry life cycle. A mature firm in an established market may implement a sophisticated approach, combining changes in all five CLASS elements to manage risk. A younger firm in a fast-growing market may need to rely heavily on formal risk control systems in the absence of well-developed cultural or structural constraints. Mature businesses may shift their risk management approach in a crisis to focus on control systems and top-down direction. Product–market strategy may also influence the practice of risk management. Wang, Barney, and Reuer (2003) suggest that firms following differentiated strategies with unique products have greater need for formal risk management systems than firms delivering commodity products or services.

In highly uncertain market conditions, such as those encountered in innovative industries, reliable business forecasts are hard to obtain. Experimentation in strategies, business models, pricing, products, distribution, and supply chains may be the norm, and the industry may be too young to have established widespread formal control systems and procedures. In such cases, management

of strategic risks could be guided in emergent fashion by innovative control mechanisms developed in tandem with the growth of the business. As we note, alignment of these elements leads to sounder overall risk management by the organization. Senior executives need to use careful judgment in adapting risk management strategies and tools to business and market conditions, and consider the interrelated elements of CLASS when making these decisions.

4. Summary and conclusions

Boards and senior decision-makers face a dual challenge: they must meet demands from regulators and investors for governance reform, and at the same time cope with major shifts in the business environment that increase the risks of conducting business. We believe making necessary improvements to meet this dual challenge is a critical task of strategic change management.

We have identified five organizational elements (CLASS: Culture, Leadership, Alignment, Systems, and Structure) that provide boards and management with an assessment tool for strategic risk. We then explore how each interconnected element relates to strategic risk and corporate governance, while considering what the research tells us in support of these relationships. Focused questions are directed at reviewing the five CLASS elements within the organization.

Boards often struggle to translate a high-level vision of strategic risk management into a program that is accepted throughout the organization. We hope our framework can help members of corporate governance committees focus on issues of risk management and build an agenda for organizational change. Effective risk management can have many benefits not restricted to the need to comply with regulation. According to Professors Chatterjee, Wiseman, Fiegenbaum, and Devers (2003), strategic risk management can be a source of competitive advantage for firms in its own right. It is hoped that the framework presented in this article is a step towards making strategic risk management a source of such advantage, and that it stimulates further discussion and effective practice.

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