

OrcaEyes Insights

HR's Role in Effective Enterprise Risk Management

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Executive Summary

Human Capital Risk is broadly defined as the workforce's ability to achieve strategic business objectives. While this broad definition of Human Capital Risk is easily understood, the ability to appropriately manage and mitigate risk within any organization's desired risk profile is a matter that requires far more detailed analysis. To be effective, one must identify key variables in risk determination, and then connect and measure these variables against business drivers to enable and facilitate management action. OrcaEyes believes the identification and management of human capital risks should be a core competency of every HR executive.

Traditionally, Enterprise Risk Management is divided into two categories: Business Risk and Financial Risk. Financial Risk relates to the way in which the Enterprise finances its activities. For example: How much equity? How much debt? What is the term of the debt? What is the debt to equity ratio? How much interest is the Enterprise paying? What percent of earnings is needed to service debt? These are among the factors used to determine an organization's Financial Risk. Financial Risk is given its own treatment as engaging in financial activities with outside firms creates the risk that external parties can severely impact, if not destroy, the business.

Business Risk covers all the Enterprise elements, other than Financial Risk, as they relate to the conduct of the business and Human Capital Risk comprises a significant part of Business Risk. With human capital spend averaging 42-percent of an organization's operating budget and workforce concerns topping the list of potential threats to companies' global strategies¹, it is critical that workforce related risks be addressed effectively.

To enable HR to significantly contribute to value creation within the enterprise, OrcaEyes has developed metrics to determine that will identify and quantify the various risks associated with Human Capital Management. OrcaEyes has categorized these risks into what we regard as the Four Pillars of Human Capital Risk Management.

This paper addresses Human Capital Risk Management as a whole and breaks it down into factors that can be addressed by Human Resources or Talent Management departments. It specifically discusses fundamental metrics that can be used by HR or other business leaders to perform a basic Risk Assessment as it relates to Human Capital.

For reference purposes, OrcaEyes refers to the International Standards Organization (ISO 31000:2009) in determining HR's role in the Risk Management process. An effective risk management program, when implemented within the framework of international standards, enables organizations to "encourage proactive management; improve the identification of opportunities and threats; improve mandatory and voluntary reporting; establish a reliable basis for decision making and planning, improve operational effectiveness and efficiency; enhance health and safety performance, as well as environmental protection; improve loss prevention and incident management; improve organizational learning and improve organizational resilience;" among others.²

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The Four Pillars of Human Capital Risk Management are:

1. **Strategic Risk:** *HR initiatives and realities affecting business strategy.* This would include the overarching human capital strategy, company culture and ethics, allocation of resources (how much does the company invest in its people), and how major initiatives are implemented (e.g., communication and change management).
2. **Operational Risk:** *The effects of HR and talent management as a whole.* Is the organization recruiting fast enough? Are there gaps in talent supply and demand and how are they being addressed? Is the performance management process effective at identifying top performers and are initiatives to retain these performers successful? This is a comprehensive talent management initiative that can determine the success or failure of an organization.
3. **Financial Risk:** *The measurement and management of the workforce's cost as it relates to the financial performance of the enterprise.* Today, HR considers such factors as compensation, benefits, turnover and organizational structure, but most HR functions are unable to tie such items as turnover, overtime and time-to-hire to indirect financial impacts, such as errors, accidents, delayed projects and lost production.
4. **Compliance Risk:** *The legal ramifications of each and every employment-related decision with a focus on such items as union relations, health and safety, whistleblowers, harassment, employee satisfaction and diversity to name a few.* More recently the compliance issue from a risk management point of view has come into significant focus. As late as 2007, some were posing the question "is risk management dead." However, the same organization that asked the question has seen a pronounced increase in attention to risk management over that past 2 years, much of it caused by the 2008 financial crisis. Risk management has since risen to the top of executives priority lists as a result of new SEC regulations passed in February 2010 mandating the board of directors' responsibility for oversight of Risk Management Policies. According to the SEC ruling, the **board must make known any risks with the potential to affect upwards of 5-percent of company earnings.**



The Four Pillars are most important because they are crucial in enabling an organization to meet its business goals and objectives. According to ISO 31000 standard, an organization must ensure they are capable of meeting objectives in terms of resources and knowledge. Obviously, people are essential resources and must have the skills, experience and competence to carry out the objectives. Companies must also have a method for identifying, measuring and reporting risk and then managing it. OrcaEyes has designed its tools and services specifically to assist employers with the identification and management of business risks.

The metrics

Accurate data is necessary to enable business leaders to make effective decisions. It justifies the initiation, acceleration, and/or elimination of strategic initiatives. Too often, good data is extremely difficult to come by in a large organization, unless the organization has a rich history of technology investment. A key challenge in aggregating data begins with the reality that internal management systems are integrated. There are supply

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chain systems, accounting systems, HR systems, talent management systems, customer relationship management systems, just to name a few. On top of those systems is often a large reporting tool, such as Cognos, used to generate relevant reports. And while all of these are great tools to support their individual functions, they do not link the workforce to key performance indicators and thus are limited in assisting HR in building a business case for critical initiatives.

Onto the metrics. Data for determining workforce related risk is broken down into The Four Pillars: Strategic, Operational, Financial and Compliance. This list below is a starting point for identifying possible areas where improvements are critical.* A few of these key statistics already reside within talent management and HRIS systems; however, to properly understand the threats and opportunities associated with the metrics, they should be mapped to organizational key performance indicators as well as the organization's more detailed business initiatives.

In order for the metrics to be relevant to line managers in operations, finance, risk management or other functions, each of these metrics must indicate a financial repercussion for shortfalls and at-risk areas. In instances where the risk area includes a billable, sales or project-based position, revenues at risk is a good measurement and powerful justification for allocating resources to initiatives directed to minimize lost revenue.

Strategic Metrics	Operational Metrics
<ul style="list-style-type: none"> • Workforce Planning and/or Organizational Readiness • Workforce Gap/Shortage • Workforce Surplus • Historical Fill Rates • Top Performer Loss Ratio • On-time delivery • HC budget overruns 	<ul style="list-style-type: none"> • Headcount and compensation costs <ul style="list-style-type: none"> ○ Headcount, Salary, Overtime, Overtime-to-Earnings, Total Labor Costs to Earnings, earnings-per-employee, Earnings-per-dollar of Human Capital spend • Aging Demographics <ul style="list-style-type: none"> ○ Includes retirement, tenure, aging distribution, • Contracts, projects, employee engagement and manager satisfaction
Compliance Metrics	Financial Metrics
<ul style="list-style-type: none"> • EEO and Affirmative Action <ul style="list-style-type: none"> ○ Includes race, EEO group, gender, age, pay by EEO classification and gender 	<ul style="list-style-type: none"> • Earning-per-employee, earning-per-dollar of HC spend, revenue-per-employee, overtime, billable services and sales

*For more insight into the data used to calculate each metric, download the SonarVision On Demand User Guide from the OrcaEyes website (www.orcaeyes.com).

Putting the metrics to use

Here is a quick look at a seemingly simple metric that tells a very big story when tied to earnings and shareholder value: Time-to-Fill. This is a real-world example of how an organization faced with paying regular overtime to its hourly plant workers can be impacted by an extended Time-To-Fill rate.

In this example, there is a tangible risk associated with the organization's human capital management practices and it affects more than 5-percent of company earnings. To understand the potential impact on shareholder value you can apply your company's pre-tax earnings multiple, being the share price divided by the pre-tax

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earnings per share (this number '14' below is assumed). The calculation below illustrates the potential impact of Time-to-Fill on a company's share price assuming a constant multiple. The most commonly used multiple is the PE (Price to Earnings Ratio) which is based on after tax earnings. However, because an after tax PE ratio can be subject to manipulation, we have chosen to use a pre tax multiple which is less likely to be manipulated or dependent on tax regime.

Through SonarVision, OrcaEyes can provide such measures as part of ongoing performance assessment and management.

Share Price	Pre-Tax Earnings	OT Costs	Time-to-Fill (Days)	Reduction in Time-to-Fill	Reduction %	OT Savings	Increase in Earnings	Potential Increase in Share Price
\$ 2.00	\$ 1,000,000	\$ 300,000	40	10	25%	\$ 75,000	7.5%	2.15

Pre-tax earnings Multiple	14	Potential Increase in Shareholder Value	\$ 1,050,000
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*For additional information on the Price:Earnings ratio calculations, visit: <http://www.investopedia.com/terms/p/price-earningsratio.asp>

In the real world, this information is then delivered to the head of plant operations and other executives within the organization who are typically managed and assessed on pre-tax revenue and earnings contributions. As a result, many of the obstacles HR and recruiting encounter in hiring hourly workers are eliminated. Hiring managers are required to interview and recommend employees in a timelier manner, recruiting budgets are increased, a new ATS is implemented, and leaders now request this information for other business units. Within this particular company, HR is promoted from a business expense to a profit center. The numbers speak for themselves. Executives at OrcaEyes have experienced this situation first-hand.

Conclusion

ISO 31000 guidelines dictate that all risk consequences “be expressed in terms of tangible and intangible impacts. In some cases, more than one numerical value or descriptor is required to specify consequences and their likelihood for different times, places, groups or situations².”

For risk analysis, the metrics highlight areas where workforce limitations will impact revenue and earnings and to what degree. They justify the need for additional resources or Human Capital Spend and identify areas where existing initiatives simply aren't effective. Once the numbers are available and accessible, effective risk management mandates they be presented to internal and external stakeholders so adjustments can be made to prevent further financial or opportunity loss.

When applying the metrics to Risk Management, they must be broken down by business unit and then tied to the overarching business strategy. When presented to business leaders outside of HR, they tell a compelling story—on that HR has struggled to tell, in large part due to lack of data and analytical tools. While there are many elements contributing to business success, the ultimate measure of that success is determined by the

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financial outcomes the business creates. By providing the same measurement framework for HR to illustrate challenges and opportunities, HR's role and value within the enterprise will be significantly enhanced.

How OrcaEyes can help.

OrcaEyes is the world's first Workforce Intelligence Solution designed to provide this specific insight to companies. This intelligence helps organizations safeguard revenue and earnings, take on new projects, identify weaknesses and fully understand internal drivers and external realities—in financial terms.

OrcaEyes' enterprise solution, SonarVision, is an easy-to-navigate system that can be integrated with existing internal systems to provide real-time access to this critical information. Companies who aren't quite ready to implement a full enterprise-wide system can begin by taking advantage of our free introductory offer with SonarVision On Demand. A quick data extraction from an HRIS and/or Talent Management Solution can be easily uploaded into SonarVision, and a detailed report reflecting your analytics, risk levels with benchmarks will be produced within 24 hours...**Risk Free!**

References

1. *According to a survey of risk management executives performed by The Conference Board*
2. *International ISO31000:2009; Risk Management Principles and Guidelines ©ISO 2009*

