



The business case for systematic risk management

On January 19, 2010, the Canadian Audit Committee Network (CACN) met in Toronto to discuss risk management practices.¹ Improving risk management continues to be an ongoing “*journey*,” as companies consider how best to integrate risk management into strategic planning and operations. The financial crisis has brought a renewed focus on these activities at many companies.

A member observed, “*In 2006, we didn’t have anything really. Risk management [formerly] amounted to insurance coverage ... It was a natural evolution from Enron, etc.*” Today, members agreed that companies are investing heavily in their risk management approach, in part because investors are increasingly focused on the topic. As one member noted, “*Risk management is the next idea on [investors’] agenda after say on pay ... They want to know about the link between compensation and risk, and how directors can overcome groupthink.*”

Risk oversight is also evolving. As members discussed during the September 2009 network meeting, the full board is increasingly assuming oversight of key risks.² Still, the audit committee plays an important oversight role. For this reason, members were particularly interested in benchmarking risk management practices at other leading companies.

Executive summary

Despite some questions about the ability of risk management to deliver new or actionable insights, most members agree that a structured, systematic approach to risk management has some clear benefits:

- **It forces a discussion of the immeasurable risks** (*pages 2-3*)

Members noted that the most important risks are often difficult to quantify. Although a formal risk management process may not be able to quantify all risks precisely, it brings them forward for discussion, which, members feel, is in itself a benefit. Members cautioned, however, that an overly detailed examination of every possible risk can cause management to lose sight of the forest for the trees.

- **It helps create a risk-aware culture** (*pages 3*)

Members reported that just having a risk management framework in place can help ingrain risk awareness in the corporate culture. This can be especially beneficial in entrepreneurial companies, where the approach to risk tends to be “*intuitive*.”

- **It focuses attention on the interconnected nature of risks** (*pages 3-4*)

When several adverse events or circumstances occur simultaneously, the effect on a company can be catastrophic. Members noted that such occurrences can bring a company down. Given that fact,

¹ *VantagePoint* reflects the network’s use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments made during the meetings are not attributed to individuals or corporations. Quotes in italics are drawn directly from comments made by CACN members before, during, and after the January 19 meeting.

² See *VantagePoint*, “[Setting the audit committee agenda for 2010](#),” October 6, 2009.



members suggested that the board press management to conduct stress tests to see how well the company handles multiple simultaneous risks.

- **It enables the board to challenge management constructively** (pages 4)

Sometimes management itself is the risk, and in those cases, board members must have the courage to speak up. A formal risk framework can act as a catalyst for conversations between management and the board on risk appetite, and those conversations can be illuminating. Members said the conversations must continue until the board feels comfortable with management's assumptions.

- **It forces companies to assign ownership of risk** (pages 4-5)

Although audit committees continue to retain a large degree of responsibility for risk oversight, there is a growing trend to have the full board oversee risk, with individual committees conducting deep dives on risks pertinent to their responsibilities. Within management, the CEO must champion risk management, but all of executive management must "own" risk.

Discussing the immeasurable risks

As companies develop more formalized risk management organizations and processes, they continue to emphasize that measuring risks requires a mix of quantitative and qualitative metrics. One network member described the process his company uses to assign values to risks: *"We rate risks based on the [potential] size, how often they are likely to happen, and multiply the impact by the likelihood and come up with a rating. Then we assign a senior executive responsibility for mitigation. We assign a number to the inherent risk if we do nothing; then if we do x to mitigate it, what is the residual risk?"*

However, despite companies' best efforts, members note that often the most important risks are the most difficult to quantify. A network member questioned, *"Reputational risk: what does it cost us? It gets foggy."* Another member observed, *"Management tends to throw their hands up on the big risks, which are often hard to quantify, and they're not sure what to do about them, yet those are often the most important."* Yet, some members suggest precisely quantifying risks is not essential: *"I am more concerned with having an understanding of what the potential impact is. Will it be a disaster or not? Then, do we have a mitigation strategy in place?"*

A network member pointed out that a formal risk management process ensures that difficult-to-quantify risks, such as reputational or political risk, get on the board agenda and added, *"They need to be on the agenda to have the discussion. I'm not sure what tools or charts you can apply. It's more gut feel."*

One member felt strongly that often a common feature of many corporate failures was that *"the strategy was incorrect or mismanaged. Robust and realistic competitive analysis was lacking."* One suggestion was for boards to work with members of management to ensure they *"blend granular reporting with broader issues"* in order to avoid getting into so much detail that they miss the forest for the trees.

Detailed reporting on all the risks companies face and how those risks are being managed can sometimes result in the most important risk areas being glossed over. For example, several members agreed that



competitive analysis is *“usually lacking [in substance],”* even though *“competition is our number one risk.”* Board members also need to push management’s natural bias toward optimism: *“You really need to ask what is the worst, worst case? How bad could it really get?”* This member added, *“Usually, companies’ strategies are hugely self-biased, assuming competition won’t change, etc., and boards rarely send it back and say, ‘Unacceptable.’”*

Creating a risk-aware culture

Members say that ensuring companies have a risk framework in place helps to ingrain risk into corporate culture, so that employees consider risk in day-to-day operating decisions. A network member stated, *“There is some value just to get people thinking about risk in their jobs.”* Another member commented, *“Risk needs to be a part of the culture, supported from management. It is only successful if people are doing it day-to-day.”*

A network member said that ultimately, having a risk management process in place is reassuring: *“I sleep better now. You are never 100% sure you’ve got all the bases covered, but I take some comfort that management is focused on risk and the potential impact of a misstep.”*

Several members said that this is particularly important in companies with an entrepreneurial culture, where risk management is more *“intuitive.”* Members sometimes encounter opposition to formalized risk management processes and skepticism about their value in that context, but one member stressed, *“It is difficult to oversee an informal, intuitive process,”* so getting something *“on paper”* improves the board’s insight into how management is thinking about risk.

Members report that outside advisers can bring an independent, broader perspective and provide a useful template from which to build a framework, though some members say having management develop risk processes actually encourages a sense of ownership and management should have a better understanding of key business risks.

Focusing on the interconnected nature of risks

One member noted that *“failure is rarely the result of a single condition, event, or bet. It is often several things occurring simultaneously that gets companies into trouble. Many times, the board was aware of individual issues, but didn’t fully appreciate the potential impact of multiple issues coming to a head simultaneously.”*

In that context, network members noted that a more rigorous risk management process helps illuminate less intuitive elements of risk. The board, often spearheaded by the audit committee, has to ensure management is considering not just individual risks, but the potential impact of interrelated risks and the potential compounding effects of multiple adverse events occurring at the same time. One member asserted, *“There is a separate role for board oversight ... to consider the interconnectivity of risks, things that are related or unrelated. How do boards get comfortable and understand how things can seriously threaten performance and the viability of the business?”* Another member noted, *“Few companies really say, ‘What if x, y, z all happen at the same time?’ We do some stress testing, but rarely together.”*



One member suggested that the board can press management to *“take the top four or five risks and see what interconnectivity exists and stress test what would happen if multiple key risks happen at once.”* One member said that his company avoids running up to its agreed thresholds on specific risks because it wants to ensure there is sufficient capacity if another risk hits simultaneously.

Challenging management constructively

A member emphasized that *“sometimes management is the risk.”* Network members agreed that a clearly defined risk framework provides a structure that enables the board and the audit committee to initiate more direct discussions with management. As one member put it, risk management has *“been a catalyst for conversations that wouldn’t happen otherwise.”* Another said, *“The process gets people talking, and you will get some surprises out of the discussion ... [It is] a process to get to a discussion of what management and the board believe are the most important risks ... It has helped to get a sense for the board’s understanding of risk relative to management.”* In a discussion prior to the meeting, a network member stated, *“The most effective way to identify risks is to get the CEO’s perspective on which are the key risks.”*

Such conversations can help illuminate important differences in perception. Members noted that it is important for the board to understand how its own risk appetite compares with that of management, but one member observed, *“We may agree that we have a low risk appetite as a company, but someone may say, ‘I don’t see this as very risky.’ It is not a defined term; it’s difficult to grab hold of.”*

Members emphasized that the board must bring an objective, skeptical perspective to risk reporting. When management is tempted to take on more risk to achieve results, the board can help management consider the true risk tolerance of the business. The goal, said one member, is to be sure *“you have the resources to withstand the risks you want to take.”* Members stressed the importance of an independent view of the major risks, and said external advisers can help validate internal risk identification efforts, especially when making a major strategic decision. As one member commented, *“When you’re about to bet the farm, it’s nice to have a second opinion.”*

A structured process also makes it less daunting to express a dissenting opinion. One network member observed, *“It takes a lot of courage to speak out against groupthink.”* Members suggested some directors, particularly those that are new to a board, may want to avoid being seen as outliers, out of step with the rest of the board. Members emphasized that the board needs to challenge management’s assumptions and push until they are comfortable, even if it means individual directors must step forward. One member suggested that one has to be more than merely *“a dissident, lone voice,”* however. This member noted, *“You need to bring [other] people along.”* It is a process, the member said, of making your case and getting a sense for what other directors think.

Assigning ownership of risk

Members discussed differing approaches to overseeing and managing risk. They believe there is an evolution taking place in many boardrooms. Audit committees often retain responsibility for ensuring risk management processes are in place; in the absence of a risk committee, they often take a lead role in oversight of enterprise risk management.



However, many companies have brought oversight back to the full board, with deep dives into selected risk areas assigned to various committees. A network member emphasized the importance of full board engagement: *“Some people say the board doesn’t have enough time to discuss risk. Add extra time for the board to discuss it if necessary.”* Some members said they have special board meetings focused solely on risk.

Ownership within management is also evolving. Members agreed that the CEO must drive risk management. In some cases, the CEO is also explicitly the chief risk officer. However, members disagreed on the merits of such an approach. Although all agreed that the CEO is ultimately accountable for managing risk, one member questioned whether a CEO would give risk management due priority among his or her many responsibilities. Others questioned whether the CEO might be more likely to push the limits of acceptable risk taking to achieve performance goals.

Beyond the CEO, other executives are involved. Business unit executives are typically assigned ownership for risks related to their businesses. In many cases, the internal audit function, or a risk management team that often includes the internal audit function, plays a significant role in monitoring and reporting on risk, but members stress that executive management needs to *“own”* risk management if it is to be effective. A network member stated, *“Some people think the risk management team owns the risk. The big challenge is getting the business unit to own the risk and risk mitigation.”* Although still in a minority, an increasing number of non-financial institutions have appointed a separate chief risk officer, suggesting such a role brings a more objective perspective.

Conclusion

Enterprise risk management is an evolving concept, and most companies and boards are still wrestling with how to apply it in a way that supports strategic and operational decision making and adds real value. Some still question whether a separate process – one that involves a significant investment of time and energy – is likely to yield results that they can act upon. CACN members emphasize that effective risk oversight requires active board engagement. The board must be sure that the potential impact of compounding risks, many of which may be outside the company’s control, is truly understood and that risk management is integrated into strategic planning, not just a separate process. Audit committees and boards can play a valuable role by bringing an objective perspective to risk discussions and keeping risk management focused on key risks to the business.



About this document

The Canadian Audit Committee Network is a group of audit committee chairs drawn from leading companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is convened by Ernst & Young and orchestrated by Tapestry Networks to access emerging best practices and share insights into issues that dominate the new audit committee environment.

VantagePoint is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management, and their advisers as they endeavor to fulfill their respective responsibilities to the investing public. The ultimate value of *VantagePoint* lies in its power to help all constituencies develop their own informed points of view on these important issues. Anyone who receives *VantagePoint* may share it with those in their own network. The more board members, members of management, and advisers who become systematically engaged in this dialogue, the more value will be created for all.

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Appendix 1: Meeting participants

- Bev Briscoe, Audit committee Chair, Goldcorp
- John Caldwell, Audit committee Chair, IAMGOLD
- Denis Desautels, Audit Committee Chair, Bombardier
- Alan Horn, Audit Committee Chair, Fairfax Financial Holdings
- Alice Laberge, Audit Committee Chair, Potash Corporation
- Jean La Couture, Audit Committee Chair, Quebecor
- David Leslie, Audit Committee Chair, Enbridge
- Jane Peverett, Audit Committee Chair, EnCana
- Ted Reevey, Audit committee Chair, Bell Aliant
- Stuart Smith, Audit Committee Chair, Yellow Pages

Ernst & Young participants:

- Colleen McMorrow, Senior Client Service Partner and Greater Toronto Area Leader, Technology, Communications, and Entertainment Industry Practice, Ernst & Young Canada
- Lou Pagnutti, Area Managing Partner, Chairman & Chief Executive Officer, Ernst & Young Canada
- Rob Scullion, Managing Partner for Assurance and Advisory Business Services, Ernst & Young Canada

The following members participated in a teleconference on the same topics following the meeting. Selected comments from that call have been incorporated in this issue of *VantagePoint*:

- Brian Canfield, Audit Committee Chair, Suncor
- John Clappison, Audit Committee Chair, Cameco and Canadian Real Estate Investment Trust (CREIT)
- Eileen Mercier, Audit Committee Chair, CGI Group
- Thomas O'Neill, Audit Committee Chair, Loblaw
- Barbara Stymiest, Audit Committee Chair, Research in Motion
- Vic Young, Audit Committee Chair, RBC



Appendix 2: Questions for audit committees

- ? How effective are the organizational and process components of your company's risk management programs?
- ? Does your leadership team support a company-wide emphasis on the importance of risk management? What mechanisms might executives adopt to ensure risk management is embedded in the corporate culture?
- ? Who (or what group) has been designated to lead the risk management activity? What prompted this choice? What supporting organization is required? How is the risk management group supported by the organizational culture and by the audit committee?
- ? What sources of external expertise does your company rely upon for risk management? What value do they bring?
- ? How is risk appetite defined at your company? Are the measures qualitative or quantitative?
- ? How does your approach to risk identification compare with those outlined above? How is your list of risks generated? What screening criteria are applied? Who participates in the identification process?
- ? What methodology is used to prioritize the list of potential risks? What quantitative and qualitative factors are taken into account?
- ? What unexpected results emerged from the risk identification and prioritization process?
- ? What tools does management use to mitigate material risks once they are identified?
- ? How does management report the status of the risk management effort? How frequently are these reports prepared? To whom are the reports distributed, and how are they used? How do companies ensure that risks are reported up through the organizational hierarchy without being filtered?
- ? How is the risk management framework used to support management decisions?
- ? How does the full board support the risk management activity?
- ? What is the nature of the risk management discussions between the board and management?
- ? Have you made any changes to the role and remit of any board committees?