



Enterprise risk and the financial crisis

Introduction

The Pacific Southwest Audit Committee Network is a group of audit committee chairs drawn from leading companies based primarily in the Pacific Southwest region of the United States. The network held its 11th meeting on October 23, 2008. This document reflects the key points of the participants' discussion of enterprise risk and the current financial crisis.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. Members' remarks appear in italicized quotes.

Executive summary

During the discussion, participants focused on four themes related to enterprise risk and the financial crisis. These are outlined below, with further detail on the following pages:

- **Surveying the economic landscape: what is happening in the markets?** (*Page 2*)

Meeting participants agreed that the economic outlook is troubling. In the short term, they expect the global economy to continue its downward slide, and they expect significant corporate cutbacks. While the participants believe government intervention is an appropriate response, they warn of unintended consequences. They believe that in addition to focusing on the short-term response to the crisis, board directors should also focus their attention on longer-term implications.

- **Responding to the financial crisis: what are companies doing?** (*Page 3*)

Meeting participants described how their companies are responding to the current economic climate and highlighted several ways companies might "buffer" themselves from the impact of the crisis: (1) cut back on spending; (2) focus on cash; (3) rethink fundamental strategic assumptions; (4) review defined-benefit pension funds; and (5) consider how to handle earnings guidance in light of economic uncertainty.

- **Enhancing risk oversight: who owns major risks?** (*Page 4*)

The crisis in the financial markets is spurring many executives and board directors to revisit and develop a more robust approach to managing risk. While meeting participants agreed that the full board has the ultimate responsibility for enterprise risk management (ERM), many believe that the audit committee can serve as an important catalyst to ensure that robust risk management processes are developed.

¹ For a full list of participants, please see Appendix 1 on page 8.



- **Risk management in action: what is the future of risk management?** (Page 6)

Participants said risk management should not stand alone, but rather should be embedded in strategic planning processes and individual business decisions. They also believe that given the dynamic nature of risk, boards and management should have more frequent discussions of risk.

Surveying the economic landscape: what is happening in the markets?

Recent changes in the economic environment have taken many board members into uncharted territory. Meeting participants described the current economic outlook as “*depressing*” and said that “*any expectation that in the next quarter or the next year we’ll be out of this problem is a hallucination. Every corner of the economy will continue to see stress and business failures. We’re not talking a couple of months; we’re talking a couple of years [until conditions improve].*”

With regard to the challenges in the credit markets, one member observed that “*there are [actually] two bubbles: a credit bubble and a derivatives bubble. The derivatives bubble has been expanding for a long time. Trillions of dollars of bets have been made that are now going to start to unwind. It took 15 years to grow and burst, and no one has noticed it until now. This derivatives bubble is what keeps me up at night.*”

Participants offered several predictions for the short-term economic outlook: “*The fourth quarter is usually the ‘up quarter,’ and now many are saying it’s going to be down [by] as much as 20%. That’s an immediate impact in terms of the real economy.*” Added another member, “*Innumerable companies are going to start having significant layoffs and cutbacks.*” A third member predicted, “*It’s going to be much harder to raise money to grow and harder to find opportunities. I think the general cost of [doing] business is going to go up.*”

Participants generally supported some form of government intervention in the financial markets: “*If the government did nothing, it would be bad. Let’s hope they continue to work to slow the panic. It’s a question of whether it will be enough.*” However, they were somewhat concerned that the larger economies might create inflation through their rescue plans. Moreover, several participants see “*an awful lot of regulations that could have far-reaching ramifications,*” including unintended consequences: “*The pendulum never seems to stop in the right place when it comes to government regulation. They usually either overcorrect or put too little into it.*”

In the meantime, participants agreed that the only certainty is more uncertainty. Consequently, boards should take a longer-term perspective: “*When you think about what’s currently going on in the world, companies can’t spend much time thinking about what the ramifications will be. There are so many ingredients that go into this complicated stew. I’m worried that what we’re seeing is just the tip of the iceberg. People are going to react to what we’re seeing now instead of what it’s going to look like 6, 12, 24 months from now. We need to think about what these changes will mean long term.*”



Responding to the financial crisis: what are companies doing?

Participants agreed that companies would have been hard pressed to protect themselves against the financial crisis, even if they could have predicted it. One member said, *“If you had known it was a one-in-a-thousand chance event, would you have done anything about it?”* Another member said, *“If someone had said a year ago that this problem would have a ripple effect, would you have done anything differently? What would you do about it if you knew it was coming? You can’t just close up shop and do nothing. In the end, you can do something to minimize the impact [of an impending economic crisis], but there’s only so much you can do.”*

Now that the crisis has struck, participants described a number of ways companies can respond:

- **Cut back on spending.** *“A real time of belt tightening is occurring at my company. We’re focusing on all the ways we can cut back on spending.”*
- **Focus on cash.** *“The first thing everyone did in reaction [to the financial crisis] was look at their cash. All corporations are working on right now is keeping that safe.”* Added another member, *“You have to shift your mind-set from things you usually think about to ‘is our money safe?’”*
- **Rethink fundamental assumptions.** *“We need to rethink the fundamental assumptions that previously had been embedded in the company and start thinking about things from the ground up. If you have a business plan set a certain way, you might have to rethink that and focus on what some of the consequences could be.”* But this process can be challenging: *“We can’t figure out our downside scenario. We’re looking at the extreme case, but we’re not sure what we’re going to do about it.”*
- **Review defined-benefit pension funds.** *“One thing we’re doing on the board of [one of my companies] is taking another look at the defined-benefit pension funds. A year ago, they had a lot of cushion, but that’s not the case anymore.”* Commented another member, *“Pension liabilities are quite a big issue for many companies right now.”*
- **Consider how to handle earnings guidance in light of economic uncertainty.** *“The budgeting process used to be fairly simple, but that has changed now. How do you define for the Street? What kind of guidance can you give in such an unknown environment?”*

In addition, meeting participants also said the financial crisis has prompted their audit committees to focus on a deeper review of their processes and relationships: *“We looked at all our relationships with financial institutions for custody, pension funds, swaps, counterparties; who our revolver banks are; who our insurance providers are for property and casual as well as D&O. We’re looking across the board at everything, so we know who our relationships are with, where we stand with them, and what we’re doing about it and if we need to change anything. We want to understand all the potential ramifications for the business.”*



Recommendations from other audit committee networks for dealing with the financial crisis

- Focus on understanding and addressing any concerns about the company's liquidity, including sources and uses of capital, access to credit, refinancing issues, concentration of risk, and counterparty risk (including insurance providers, key customers, and key partners, e.g., in the supply chain or joint ventures)
- Pressure test the balance sheet with a line item review of assets and liabilities
- Request additional details from management about exposures resulting from financial instruments
- Continuously review the company's defined-benefit pension fund and treasury investments
- Move selected technical and disclosure discussions from the audit committee to the full board
- Be vigilant about financial controls, as management may be tempted to shift losses forward
- Add "changes in the risk profile" to every audit committee and board agenda
- Revisit the internal and external audit plans in light of the changing risk environment
- Given continued economic uncertainty, discuss what to do about providing annual earnings guidance
- Discussions with the company's external auditor can help audit chairs focus on the audit firm's likely year-end opinions on pension funds and impairment of intangibles and goodwill

Enhancing risk oversight: who owns major risks?

As the financial crisis continues to grip global capital markets, financial media, shareholders, and regulators have zeroed in on failures in ERM as one of the key drivers of the economic meltdown. Consequently, boards and audit committees in all sectors are revisiting their companies' approaches to managing enterprise risk. While participants agreed that *"risk is inherent in everything,"* they believe boards have struggled to get a handle on risk management, and they note that increased interest has not always led to increased clarity.

The importance of leadership

Committed leadership, participants agreed, is essential for effective risk management. Management must ultimately drive the process: *"When you look at risk management as a company, we as directors aren't going to make a good program work if management is not committed. This doesn't mean they have to go around chanting 'ERM'; it has to do with the quality of the process they have in place."*

Specifically, participants said that an enterprise-wide view of risk has to be both embraced and driven by the CEO. As one member pointed out prior to the meeting, *"There's no doubt that it has to be the CEO that understands the full extent of the risk they are getting into. If you have a CEO that doesn't understand the risks, then you should get into the discussion of whether or not you have the right CEO and management team in place."*



Participants reported that some managers are initially skeptical of the value of a formalized risk management process: *“Originally when we brought it up to management, they said [halfheartedly], ‘Yes, let’s do that some time ...’”* However, members at the meeting remarked, *“I don’t think you would ever hear a CEO now say [adopting an ERM process] is a waste of time.”*

Some lingering concerns do persist, including the fear of creating a bureaucracy. Additionally, participants report that some executives are apprehensive because of their recent experience with Section 404: *“[They] have all just lived through the horror of implementing [Section] 404, and they don’t want to go through it again with risk management ... People are worried it could happen again with ERM.”*

Nevertheless, almost all participants said their management teams are *“embracing and embedding a more formalized risk management process”* and that boards *“expect management to be on top of ERM in terms of what needs to be done.”*

Governance of enterprise risk management

While members at the meeting agreed that the full board has the ultimate responsibility for ERM, some wonder how the full board can play an effective oversight role. Participants generally agreed the audit committee can play an important role as a catalyst to ensure that risk management processes are developed.

Participants acknowledged that ownership of risk continues to be an ongoing discussion: *“Every board grapples with the questions, ‘What is oversight? How far does it go?’”* One member said responsibility for risk oversight tends to *“come like a hand grenade, where it’s lobbed from one committee to the next.”* Still, participants ultimately agreed with the audit chair who remarked prior to the meeting, *“There is the question of who owns ERM and then there is the more important issue of who is responsible for ERM. Who is responsible? Everyone is!”*

Meeting participants agree that while the audit committee plays a critical role in the risk management process, this need not be a time-consuming activity: *“As an audit committee chair, all I do is stir the pot for management.”* Participants generally concurred with the audit committee chair who said, *“I think a lot of the confusion and mystique around ERM has been at the board level, but I think as people have thought about it more and the audit committee has taken ownership of a process to get things started, they understand that ownership [of risk management] is much broader.”*

Identifying and prioritizing key risks

Members at the meeting agreed that the first steps in any risk management process are to identify and prioritize the most significant risks to the business: *“I think the key question for me is, ‘How do you handle a process that is both robust and simple [in a way] that will help you to truly identify the risks that are most important, without making it an over-burdensome process?’”*

Several participants described ways key risks are identified at their companies. One said, *“I think using the [risk disclosures in the] 10-K is a good place to start. It gives you a 50,000-foot enterprise-wide view that sometimes doesn’t get discussed.”* Another offered, *“At one of my companies the management team – led*



by the CEO and the C-level people – went through a process where they went four levels deep in the company and came back and identified the most significant risks they face and then talked about what they’re doing about it. They met with the board and agreed on where oversight would be. It’s going to be a process we refresh and update on an annual basis. I think as a process, it is one which is approached thoroughly and diligently, and now we have a structure in place that has top-level oversight.”

Participants noted that having a formalized risk management process can also be beneficial when it comes to prioritization: *“If you have a way to categorize risk, then that enables you to say, ‘OK, there are five or six really big risks, 12 that are significant, and then there may be hundreds of less-significant ones.’”* Although participants said there is no exact number of risks for the board to target, one member said, *“How much more time is there? I don’t think a board has time to look into more than a half-dozen risks.”*

Risk management in action: what is the future of risk management?

Risks are not static; they are dynamic. Indeed, meeting participants stressed that effective risk management is not a onetime goal that can be achieved and checked off a list; it is an ongoing process that requires continuous review and revision. Participants believe that being able to grasp the dynamic nature of risk is an important first step toward effective enterprise risk management. One member remarked before the meeting, *“I think the big mistake is people trying to make ERM a process in and of itself as opposed to ongoing risk management, identification, mitigation, and evaluation. It’s about the way we operate and the way we continuously monitor how we do business.”*

Participants highlighted several ways boards can work to ensure risk management is a continuous process:

- **Engage and educate the board.** One member noted, *“The number one thing is that it’s important for boards to be engaged and educated on all the issues that impact the business. You should have a dialogue and be talking about the assumptions that go into the business, and should be able to challenge the thinking.”*
- **Integrate ERM with the strategic planning process.** One member, speaking about the annual board retreat on business strategy, said, *“How much of the time do you get talked to, and how much of the time do you actually have a discussion? We need to actually talk about this [risk] stuff. Hopefully you have people that will engage on the actual issues.”*
- **Embed risk management in business operations.** One member observed before the meeting, *“The real question is whether the [risk management] process is embedded in the way the company plans and operates its business on an ongoing basis, and if the company is always making an effort to improve its [risk management] processes.”* Another member commented, *“I think sometimes we try to separate risk from the business of managing the business, and that’s not right. They are too linked to try to separate.”*
- **Rotate committee chairs.** *“One of the things that can be done structurally to help with risk management is to get fresh eyes to look at these things. At [one of my companies,] we’ve had some turnover where we look at the nomination of directors for election and the committee chair elections.”*



What we've found is [that] when you have a change in chair, you start rethinking what's important. It reinvigorates the discussion."

- **Bring in outside experts.** *"The board needs to constantly be briefed on what's going on in the external environment. We [often] bring in an outside expert or a speaker to come in and talk to us."*

Participants pointed out that while it is rarely identified as such, management succession is a key risk for nearly every company: *"Succession planning might not show up in the risk framework, but it's a major risk that should be covered."* The increasing pace of CEO turnover concerns some members: *"No one has as much control over risks as the CEO. This is one of the most significant areas of risks [in itself], so the board better have some view of the long-term interest of the company."*

A formalized risk management process that survives the CEO can address succession concerns: *"Some of these processes really do need to be institutionalized so they don't come and go with the executive group."* Additionally, the board can help ensure continuity by working with the next tier of management: *"The board needs to be more engaged with the next level down. The [management] transition doesn't always go well, and that can be bad from a risk management standpoint."*

Participants agreed that when it comes to overseeing a wide range of complex, dynamic risks, *"[directors] can no longer afford to just show up to a board meeting five times a year. It's a disaster if you do that. You need to be engaged and available at all times."*

Conclusion

With the financial crisis and the global economic slowdown dominating headlines, boards of directors, audit committees, investors, and regulators will all be keeping a close eye on enterprise risk. Audit committees can be catalysts for improved risk management by encouraging management to take a number of steps, including thinking about risk in a more systematic way, considering and analyzing alternative scenarios, creating mechanisms to identify changes in risk, and integrating risk management with existing strategic planning and operational processes. Members at the meeting agreed that enterprise risk management is an evolutionary process, and companies should not wait until they have a clear road map to start. After all, as one member said, *"I think we're all paddling in the right direction, but there's no one-size-fits-all [solution] when it comes to risk."*

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Appendix 1: Participants at the October Pacific Southwest Audit Committee Network meeting

Between them, the members of the network participating in the October 23, 2008 meeting sit on the boards of over 10 large-, mid-, and small-cap public companies:

- Henry DeNero, Western Digital
- Mike Fisher, Insight Enterprises
- Bala Iyer, IHS
- Mike Stein, AIMCO

The following members contributed to pre-meeting discussions, but were unable to attend the meeting:

- Barbara Alexander, Qualcomm
- Frank Biondi, Amgen
- Joe Bronson, Jacobs Engineering Group
- Richard Dahl, DineEquity
- Ray Dittamore, Invitrogen
- David Engelman, Fleetwood Enterprises
- Mike Fisher, Insight
- Steve Frank, Northrop Grumman
- Diana Laing, Macerich
- Lou Lavigne, BMC Software
- Marty Melone, Internet Brands
- Mike Meyer, City National Corporation
- Debbie Reed, Genentech

Ernst & Young partners participating in all or part of the meeting included:

- Bill Browning, PSW Sub-Area Assurance Leader and Los Angeles County Office Managing Partner
- Ian Eddleston, Partner and IFRS Market Leader
- Peter Griffith, Pacific Southwest Area Managing Partner



Appendix 2: Selected questions audit committee members and other board directors might ask themselves about enterprise risk

- ? What is the business case for a formal risk management process? Consider the benefits and costs of overseeing different types of risk (strategic, compliance, and operating risks). Is there a different business case for each?
- ? Why are so few companies successfully implementing formal risk management processes? Has the credit crisis made the case for ERM stronger or weaker? Has the crisis caused your companies to reexamine their approach to risk management and oversight?
- ? How should the board determine which risks are overseen by the full board? By the audit committee or other board committees? Under what conditions should the board create a committee to oversee specific risks?
- ? How much risk oversight is enough? When should a specific risk be reviewed by the board?
- ? What questions should the board, or the audit committee, ask management about its current risk management program? How can the board or audit committee evaluate the quality of the answers?
- ? What processes does management use to identify and prioritize risks? How does management ensure that key risks are being mitigated and that the work is being coordinated?
- ? How regularly does the board or the audit committee assess management's appetite for risk? What other lessons relating to risk management has the credit crisis taught us?
- ? Consider the most significant risk miscalculations over the past five years. How can companies avoid systemic risk-management blind spots?
- ? How might companies more effectively integrate risk management and strategic planning processes? What sort of risk management framework can effectively evaluate both strategic and tactical risks?
- ? As a board director looking to manage your own personal risk, how do you think an "ideal" risk management and oversight program should look? What barriers prevent such a program from being implemented today?