CANADIAN
AUDIT COMMITTEE NETWORK
VantagePoint

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Risk management: in search of a practical approach

Introduction

The Canadian Audit Committee Network is a select group of audit committee chairs drawn from leading Canadian companies. 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 evolving audit environment.

The second meeting of the network was held in Toronto on November 7, 2006, and focused on practical ways for boards and audit committees to effectively oversee enterprise-wide risk management.

This document reflects a synthesis of the key issues that emerged from the meeting. The ultimate value of *VantagePoint* lies in its power to help all constituencies develop their own informed points of view on important issues such as these. Anyone who receives this publication may share it with those in their own network. The more broadly we can disseminate this information to board directors, management executives, and their advisers, the greater the value created for all.

Between them, the members of the network who participated in the meeting sit on the boards of over 30 large-, mid-, and small-cap public companies. The attendees were:

- Mike Boychuk, Audit Committee Chair, Yellow Pages Income Fund
- John Caldwell, Audit Committee Chair, Cognos
- Gary Colter, Audit Committee Chair, CIBC
- Don Fullerton, Audit Committee Chair, Husky Energy
- Bob Luba, Audit Committee Chair, MDS
- Eileen Mercier, Audit Committee Chair, CGI Group
- Tom O'Neill, Audit Committee Chair, BCE
- Ted Reevey, Audit Committee Chair, Aliant
- Pierre Robitaille, Audit Committee Chair, Gildan Activewear

Also attending the meeting were:

- Lou Pagnutti, Area Managing Partner; Chairman and Chief Executive Officer, Ernst & Young Canada
- Rob Scullion, Managing Partner for Assurance and Advisory Business Services, Ernst & Young Canada

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.

Executive summary

Members of the Canadian Audit Committee Network agreed that risk management activities are fundamental to a well-run corporation. They discussed practical ways in which the board and the audit committee can oversee these activities. The issues members found to be most important are highlighted below, with more detailed discussion on the following pages:

- **Making the case for risk management** *(page 3)*

  Risk exists within all organizations. If poorly managed – or unmanaged – risk can destroy companies and ruin reputations, but a well-organized risk management process can create opportunities for significant growth and profitability and contributes to overall financial well-being by improving the quality of governance. Research has shown that investors are willing to pay a premium for companies with clear risk management procedures.

- **Obstacles to successful risk management** *(page 4)*

  Even with a clear understanding of the importance of a rock-solid risk management plan, boards and committees still face difficulties in implementation and execution. One problem is gradualism – slow changes over time that are appropriate in isolation and approved by the board, but that over time and collectively, can move a company from sure footing to uneven ground. Another is the "perfect storm" phenomenon: a multitude of small risks, all of which could have been mitigated independently, hitting a company at once. As individual threats, they may pose little danger, but as a collective strike against the organization, they can be devastating.

- **Risk oversight and the board** *(page 5)*

  Despite the difficulties boards face, there are a number of ways that boards can approach risk management oversight. Activist directors and solid leadership from the executive team can send the message throughout the organization that risk is to be understood and managed. Outside advisers can provide the board with a fresh set of eyes and an independent opinion about the state of risk in the company. Lastly, a formal risk committee of the board can provide comprehensive oversight for risk issues at the board level.

Making the case for risk management

Members agreed that board directors, management, and stakeholders *"want [companies] to take managed risks,"* but stressed the word "managed." Effective risk management *"prevents serious stakeholder damage"* and reduces potential director liability. One member asked, *"[When things go wrong,] where does [accountability] lie? With the CFO? The CEO? The board? At the end of the day, fingers get pointed."* Another member agreed: *"It's very embarrassing; you don't want to watch your reputation go down the drain."*

Risk management is important, but members cautioned that *"you need to do [risk management] in a balanced way, so you don't turn the company upside down."* One member noted that *"the process of identifying risk contributes to avoidance and management."* Another member agreed: *"In an environment blessed with greater opportunity and threats, you're likely to halve the surprises and threats [by assessing risks.]"* The process also provides the company with a *"mechanism for channeling a more coherent discussion on the choices being made."*

Furthermore, risk management may lead directly to shareholder value. One member argued that risk management contributes to effective governance and said that investors are willing to *"pay a premium for good governance."* There is evidence to support this view. According to the Ernst & Young report *Investors on Risk: The Need for Transparency*,

- Nearly a third (31%) of investors surveyed say they expect the board of directors to establish the company's risk management strategy
- More than half (53%) expect the board to provide management with the guidelines for managing risk
- More than three-quarters (82%) said they would pay a premium for a company that can demonstrate a successful approach to risk management
- Nearly half (48%) said they had walked away from a company whose risk management performance was inadequate.[1]

Directors should not, however, fall into the trap of expecting risk management to deliver a documented, calculable return on investment. As one member stated, *"ROI isn't practical. You have to do a downside analysis: You can't* not *do [risk management]."* Another agreed: *"I'm not sure you'd measure it. You need to spend that money. If you don't, there's a potentially devastating impact."*

[1] Ernst & Young, *Investors on Risk: The Need for Transparency*, (New York: Ernst & Young 2005), 7, 10. Complete PDF available at http://www.ey.com/global/download.nsf/International/Global_Risk_-_Investor_Survey_Report/$file/EY-Risk-Investor-Survey-Report.pdf.

Obstacles to successful risk management

It can be difficult to execute a risk management program, even for companies that fully embrace the benefits. Members raised two specific issues that complicate matters: gradual and almost imperceptible increases in risk, and a "perfect storm" caused by concurrent risks that would not be problematic in isolation.

The risk of gradualism

While boards may receive periodic updates on systematic, apparent, and foreseeable risks, they often fail to recognize the significance of risks that grow incrementally over time. As one member said, *"What happens in real life is that gradualism occurs. A little change here, so it's not reported to the board. A little more here. Boards are happy, but the ground is shifting under them. The warning signs are ignored because they're so small. But they're there in almost every case, and so small individually, and so rationally explained in the competitive market, that no director is even moderately uncomfortable."*

In an e-mail after the meeting, a member provided two examples of how gradualism has affected companies in the past: *"[In one industry], competent boards authorized a series of union settlements over many years, for various reasons, until such time as the net effect was unsustainable. On the tax side, more and more complicated tax reduction schemes deemed legal at the time, approved by corporate boards, and accepted by the [Canada Revenue Agency] some for lengthy periods – eventually overstepped the [CRA] patience and were reversed. Two quite different situations, but creating risk which eventually had to be addressed if the [involved] companies wished to stay in business."*

So how does a board counter the effects of gradualism? One member advocated *"committee rotation to get a fresh set of eyes on problems."* Another agreed, and noted, *"The average tenure of a board member at [a market-leading company] was 24 years. They were asleep as [a major competitor] sailed by."* In addition to rotating directors through board committees, another member suggested focusing on the mind-set of the directors. *"The five worst words,"* he said, *"are, 'Everyone else is doing it.'"*

The perfect storm

In his 1997 book *The Perfect Storm*, Sebastian Junger described a simultaneous occurrence of events whose chance combination proved devastating. Members say board directors need to be mindful of the potential for such a phenomenon in the corporate arena. As one member put it, the concern *"is not one risk, it's a perfect storm. For example, experiencing a lousy capital structure [at the low point in a] cyclical business. It happens all the time."* This concern is amplified on boards that have different committees to address different risks. Each can view the risks it is facing as inconsequential, but the combination of risks could destroy significant shareholder value. One member described an experience from earlier in the member's career, in which the company struggled as a result of the combined effects of *"bad leadership, bad capital [structure], and [a] bad cost structure."*

Risk oversight and the board

Drawing on both successful and unsuccessful experiences with risk, network members had a number of recommendations for addressing risk management in corporations.

Four ways to support risk management more effectively

- **Have good leadership at the top.** From activist directors to supportive executives, it's vital that leadership makes risk management a clear priority for the organization.
- **Engage independent experts.** By using outside experts and advisers, directors may become aware of issues or solutions they had not considered.
- **Treat risk management as a strategic enabler.** Risk management should not be seen as an impediment to growth, but rather as a program of activities that supports and enables the execution of corporate strategy.
- **Establish a board-level risk committee.** Creating a separate risk committee allows for a comprehensive and holistic view of risk. As one member noted, *"a separate risk committee won't run out of work."*

People: the biggest risk, the most likely answer

Even though management must take ownership of risk management, members feel the board has to play an active role overseeing risk management. *"Activist directors are absolutely vital,"* one member said. *"They suggest alternatives and are committed to shareholder value. The [audit committee] chairman, above all, has a big role in setting that tone and pace."*

Members said it was especially important to build relationships not only between members of the board and senior management, but also between the board and lower-level managers. One member noted, *"People are your major risk. If you don't know your key executives, you're taking on huge risks. Know the people you're dealing with first."* Another member recommended that directors *"get beyond senior management. You get all the best stories [lower in the organization]."* Members say that while systematic analysis can be valuable in certain circumstances, assessing people requires intuition, and *"intuition is an art, not a science. It's a very human process."* Another agreed: *"You have to see the body language and get a feel [for what's going on]."*

In addition to knowing the right people throughout the organization, it's *"absolutely critical"* that the board be sure the CEO and other senior executives are making risk management a clear priority. However, whatever its involvement in risk management oversight, the board must make sure not to cross the bright line into management. *"If you don't want to interfere,"* one member said, *"you have to trust management. It doesn't have to be an intrusive process."*

Peering in from the outside

One member cautioned against presuming that management and the board have an accurate view of potential risks, noting, *"Risk might not be where you think it is."* Another member cautioned the group, saying that too often, *"[We board members] drink our own bath water"* and make too little use of independent risk assessments. An August 2006 survey of Canadian companies conduced by Ernst & Young agrees: "A significantly smaller proportion of Canadian companies (24%) have had their risk management approach evaluated by an independent third party, compared to 52% of companies globally."[2]

A board that one member sits on brought in a Big Four accounting firm to support the risk management process. The member reported that the accounting firm helped *"identify risks at the operational level, and financial risks. It led to a six-hour discussion at the board."*

Treating risk management as a strategic enabler

One member reminded the group that sometimes *"you pay the CEO to maximize risk [in order] to increase profits."* The challenge for boards is not to eliminate or even necessarily to reduce risk; rather, boards should seek to ensure that the company's risk profile is consistent with its strategy. Instead of impeding growth, a properly constructed risk management framework can actually free management to accept a certain degree of risk while aggressively pursuing growth opportunities. Unfortunately, risk management is not always viewed as an enabler, and some employees *"may see it as excessive and unnecessary."*

One member observed that for a risk management program to be most effective, *"it must be viewed positively. It's helpful in identifying and quantifying risks without being seen as 'the guy who kills everything.'"* Another member said, *"[You want to get to a point where] operations will call risk management to say, 'come help me.'"* Another agreed: *"[It will help us] meet higher standards, to be more creative and responsive to needs … It may make us more astute and able to deliver better [service]."*

Forming a board-level risk committee

Directors often note that while the full board is ultimately responsible for risk oversight, it is usually impractical for boards to dedicate adequate time to in-depth discussion of all key risks, given the number of other items on the typical board agenda. While audit committees could potentially take the lead in risk oversight, members note that audit committee agendas are already full, and there is little capacity to take on still more responsibilities. Furthermore, as one member noted, *"To me [risk management is] a team sport. There are risks that an audit committee doesn't understand. Food safety at [a grocery chain], for example. Oil rig guys at pipeline companies."*

Given the importance of risk management as a driver of value, many financial services companies have formed board committees to oversee enterprise-wide risks. One member argued that this practice need not be restricted to a narrow set of industries and suggested that *"companies [in any industry] of a decent size should have a risk committee. A separate risk committee won't run out of work."*

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[2] Ernst & Young, *Risk Management in Canada: Moving Beyond Assessment* (New York: Ernst & Young, 2006), 12. Available for download at http://www.ey.com/Global/download.nsf/Canada/Risk_Management_in_Canada_2006/$file/15398_Can_Risk_Survey.pdf.

While members were intrigued by the proposal, some questioned its practicality. Most directors already serve on multiple committees, and a new committee would only increase workload. Alternatively, boards could add directors in order to support the new work, even though this could decrease the efficiency of the full board. One member asked, *"How many directors do we need? [Do we] ask them to serve on three committees and the board? The [director] training schools could rev up ten times, and I'm not sure we'd have the right people."* One member suggested that due to the workloads involved, *"directors should serve on the audit committee or the risk committee, but not both."*

Alternatively, some boards may create a temporary subcommittee to ensure that all risks have been identified and allocated to the appropriate permanent committee. One member described such a situation, in which a temporary risk management subcommittee evaluated alternatives and determined that *"operations risk [should go] to the governance committee. The audit committee gets financial risk. HR gets [people issues]. And basic business risk is a board issue, a standing agenda item."* This subcommittee was chaired by the Chairman of the Board and supported internally by *"the CFO, in-house council, and the HR head."*

Conclusion

One member noted that 20 years ago, *"risk management was [nothing more than] getting a good insurance broker."* Times have changed, and organizational processes have changed too. Companies need to address risk in a more systematic manner, considering changes in risk as well as the interrelationships between risks. The audit committee chair can play a valuable role in making the board aware of these issues by raising the points covered in this document for discussion by the full board.

The views expressed in this document represent those of the Canadian Audit Committee Network, a select group of audit committee chairs from Canada's leading companies committed to improving the performance of audit committees and enhancing trust in financial markets. They do not reflect the views nor constitute the advice of network members, their companies, Ernst & Young or Tapestry Networks. Please consult your advisers for specific advice. Ernst & Young refers to all members of the global Ernst & Young organization.

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