SOUTHEAST
AUDIT COMMITTEE NETWORK
VantagePoint

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Enterprise risk

Introduction

The Southeast Audit Committee Network held its 11th meeting on September 9, 2008, to discuss International Financial Reporting Standards (IFRS)[1] and the audit committee's role in enterprise risk. This document is a synthesis of insights and comments from the discussion on enterprise risk. During the discussion, members focused on the following topics:

- **The credit crisis and enterprise risk**
- **Connecting the dots: strategy, risk, and incentives**
- **Oversight: expanding the board's thinking about risk**

Collectively, members of the network in attendance at the September meeting sit on the boards of more than 25 large-, mid-, and small-cap public companies. Audit committee chairs attending were:

- Eddie Adair, Tech Data
- Denny Beresford, Kimberly-Clark and Legg Mason
- Kerm Campbell, SPX
- John Farrell, Fidelity National Financial
- Renée Hornbaker, Eastman Chemical Company
- Sherrill Hudson, Publix Super Markets, Inc.
- Claude Lilly, FairPoint Communications
- Dean O'Hare, HJ Heinz
- Jim Robbins, DSW
- Erik van der Kaay, RF Micro Devices
- Edwina Woodbury, R. H. Donnelley

Also participating in the meeting from Ernst & Young were:

- Edwin Bennett, Southeast Area AABS Managing Partner
- Tom Hough, Vice Chairman and Southeast Area Managing Partner
- Chuck Seets, Southeast Area Partner
- Ron Weissman, Partner, Financial Services Practice

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.

[1] See Southeast Audit Committee Network, "International Financial Reporting Standards," *VantagePoint,* September 2008. Available at http://www.tapestrynetworks.com

Executive summary

Members focused on three themes related to enterprise risk and the audit committee:

- **The credit crisis and enterprise risk** *(Page 2)*

  The crisis in the financial markets is spurring management and directors of many companies to ensure they have a robust approach to managing risk. Members discussed three significant ways in which the credit crisis is affecting the companies on whose boards they serve.

- **Connecting the dots: strategy, risk, and incentives** *(Page 3)*

  Enterprise risk and corporate strategy go hand in hand. Directors try to ensure that executives' compensation plans both address risk and encourage the execution of strategy. Boards are more and more aware of how incentives such as stock ownership impact management's appetite for risk, and they report closer collaboration between those responsible for strategic planning, enterprise risk, and financial compensation to ensure that executives are appropriately compensated in good times and in bad.

- **Oversight: expanding the board's thinking about risk** *(Page 4)*

  Enterprise risk is a team activity: the board works with management, and the audit, compensation, and risk committees of the board work together. Enterprise risk efforts need a strong leader in the organization, one who is familiar with the business first and enterprise risk processes second. Failure to have a strong risk leader (be it a chief risk officer, the CEO, or some other executive) is itself a risk; successful leaders help the company predict and mitigate risks, allowing the company to grow and thrive. In overseeing these efforts, the compensation, audit, and risk committees and chairs collaborate, share information, and make sure enterprise risk efforts are integrated and comprehensive across the entity. External advisers, both on specific risks and the risk management process itself, help, and outside experts in other fields can help directors expand their thinking.

The credit crisis and enterprise risk[2]

The credit crisis is having a profound impact on public companies, including those outside of the financial services industry. Members described a number of situations that are impacting the companies on whose board they serve:

- **Problems identifying financial and other risks to the company.** One member said that now, *"no matter how much you know [about your financial situation], you question what's lurking in the background."* Another agreed, saying *"Not only am I concerned with the initial financial impact, but also the second-, third-, fourth-, and fifth-order impacts … the eventual impact on future business operations."*

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[2] For the purpose of this document, enterprise risk management is defined as the process by which organizations identify, assess, control and monitor all material risks. Such risks include: Financial, operational, regulatory, environmental, legal, reputational, etc. For a more comprehensive definition of enterprise risk, please see: http://www.ey.com/Global/assets.nsf/International/AABS_RAS_Managing_Risk_Across_Enterprise/$file/AABS_RAS_Managing_Risk_Across_Enterprise.pdf.

- **Risk cascading from financial institutions' difficulties.** *"We've taken note of our concentration of credit risk,"* said one member. *"We looked at the banks we do business with. It's the first time we've looked at the viability of our financial institutions."*
- **Adverse effects of difficulty obtaining credit.** *"We need financing right now,"* said one member. The member reported that inability to get it will *"confound all our strategy work for the past three to four years."* Another member's company escalated the pace of some financial activities *"because we don't know what the financial situation will be like in 2009."*

The credit crisis has also significantly raised the profile of enterprise risk. One member commented, *"It's a relatively serious topic that a lot of boards have not been giving enough attention … That's changing now."*

Connecting the dots: strategy, risk, and incentives

Any conversation about enterprise risk involves a discussion of corporate strategy, which is natural given the solid relationship between them. One member pointed out that in the course of developing and executing a corporate strategy, *"risks pop out down the path. We have to identify them and adapt the strategy."* Both strategy and risk *"can change midstream,"* given environmental and competitive forces, and both *"involve a comprehensive look at the whole enterprise."* At some companies, *"the board is always challenging management on their strategy … Management does the strategy, but [as directors] we want to be comfortable with it. Management should work with the board."* Another member said, *"The board and management make the strategy. It's an iterative and growing process."* On the topic of risk, one member said, *"Management is responsible for risk, but we raise questions."*

Although companies may want to address strategy and risk together, in an integrated fashion, many aren't quite there yet. *"Our process isn't well established,"* said one member. *"We have a good start. We want risk and strategy linked, and we do a formal review every two years to monitor this. We won't get too far behind. It's helpful with developing compensation plans."* Many members report that compensation is a critical motivating factor for management: *"Management is involved in identifying the risks associated with the strategy. There's a degree of risk avoidance, a fear of missed bonuses"* because of risk-related performance issues.

While the audit committee's role in overseeing financial risks is clear, members reported addressing a wide range of other risks and even reviewing the risk management process itself. In some cases, *"the audit committee does the legwork [on risk management], but the full board addresses key risks."*

Monitoring management's appetite for risk

Directors are clear on the importance of *"balancing risk relative to the fear of failure."* For many directors, *"There's a risk in doing M&A, and there's a risk in not doing M&A. If management is risk averse, but the board is pushing them, there's a risk of not taking risks."* This hit a chord with many members. One remarked that *"being risk averse is one of the biggest risks you can take."* At most companies, risk taking is either encouraged or discouraged through financial incentives, including variable pay and stock ownership plans.

There is a wide spectrum of risk appetite among executives, and many members saw a direct correlation with the levels of executive stock ownership: *"Executives who own lots of stock often don't take risks. They fear losing their money,"* one member said, and another observed, *"Stock-owning C-level executives … don't have options; they have real skin in the game."*

Of course, an emphasis on stock can go too far. One member noted that *"in the offices at Enron, the current stock price was visible on every single floor."* While most members said that they had targets for stock ownership by grade, many encouraged common sense to prevail. *"There's no black mark on the CEO for selling stock,"* one member said. Another agreed and said, *"We provide finance counsel to executives [regarding appropriate levels of stock ownership] … There needs to be moderation. Not every half dollar has to be in the game."*

Reviewing variable compensation plans

Performance-based compensation measures are especially tricky, and now more than ever, given that, as *Fortune* has stated, "in this market, losing less means winning big."[3] Directors are reporting closer collaboration between the audit committee and compensation committee on variable compensation programs: *"With regard to our compensation program, the audit committee chair reviews it for perverse incentives,"* one member said. *"The compensation committee is more sensitive to these things today." "Compensation plans exist to push executives to achieve goals,"* one member said. *"If we see a problem developing [because of it], we put the brakes on before mischief happens. It's a balancing act."* For more on these efforts, please see "Collaboration and information sharing at the board level," on page 5.

Oversight: expanding the board's thinking on risk

Members shared how they had both increased their awareness and expanded their oversight of risk by using the resources available to them inside the company and through discussions with people in other organizations.

Ensuring strong internal leadership

A strong enterprise risk leader, running a comprehensive enterprise risk program, will make the board *"aware of risks, so we [can work to] mitigate them."* The current financial crisis *"has highlighted the importance of someone running enterprise risk management [ERM] who knows the business inside out, more than they know ERM inside out. Someone who grew up in the business, has run a profit center, someone who knows where the skeletons are buried."* Members endorsed this emphasis on intimate familiarity with the business, even if it may be difficult to obtain in a large, complex and global business. One member shared that *"we hired someone who had run ERM at [a major company], had all the qualifications, but didn't know our company. Within 18 months, it became obvious that we weren't making the progress we should have."*

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[3] Shawn Tully, "Jamie Dimon's SWAT Team," *Fortune,* September 2, 2008, 66. Available at http://money.cnn.com/2008/08/29/news/companies/tully_dimon.fortune/index.htm.

Many directors argue that a chief risk officer (CRO) or other enterprise risk head is simply a facilitator, and that the CEO is ultimately the company's first risk officer. The Audit Committee Leadership Network in North America reached a general agreement that an "enterprise-wide view of risk has to be both embraced and driven by the CEO."[4] On another occasion, discussions with CEOs and CROs led to the conclusion that "ultimately, it is the CEO who has final responsibility for ensuring that a company manages its risk effectively. Although CEOs do take the concept and execution of ERM seriously, it is critical that this support is more than lip service. Across our discussions, CROs felt they had the CEO's support, but one interviewee questioned whether the CEO would maintain the necessary commitment to ensure the ERM program's success: '[The] CEO is supportive of having ERM; I'm just not sure he is willing to do the hard work. If we can't get the CEO aboard, [ERM] won't work.'"[5]

Firsthand learning

Several members spoke of *"really getting involved with senior management by spending a day at the company. Some of our directors do it, others don't. Those that do can ask better questions on the strategy and succession planning. If you can get those two things right, the rest will fall into place."* Other members agreed with this and said they encouraged other directors to *"wander the floors. People love it."* Some individuals felt that not only does it help with overseeing business operations, but also *"with succession planning. This helps showcase up-and-comers in the company."*

Some boards also create full-day educational sessions to help directors broaden their thinking. One member spoke of *"creating a question-and-answer panel. Guests included representatives from a trade group and a tax lobbyist, a Delaware court judge, and others."* This full-day meeting and dinner, with 16 board members and eight guests, *"was the highest-rated meeting we ever had."*

Using external advisers

While directors have a multitude of internal resources to help guide them on risk, those sources may not be able to provide the necessary skills or information. One member flatly said, *"Internal audit? They don't offer insight."* In such a situation, directors turn to outside expertise, either for information regarding specific risk issues or for broader enterprise risk advice. One member reported, *"Reputational risk is a huge problem, and we use consultants to guide the committee's views of reputational risk issues. They were hired directly by the audit committee."*

Other members have sought out external advisers not to advise on the risks, but on the risk management process itself. One member *"brought in a Big Four consulting practice to help with enterprise risk, to create the framework and process for risk identification and management. They don't advise on the risks themselves, but simply on the structure we use."*

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[4] Audit Committee Leadership Network, "Enterprise Risk Management and the audit committee," *ViewPoints,* December 22, 2003, 6. Available at http://www.tapestrynetworks.com/documents/Tapestry_EY_ACLN_Dec03_View3.pdf

[5] Audit Committee Leadership Network, "The CRO's perspective," *InSights,* June 30, 2006, 3. Available at http://www.tapestrynetworks.com/documents/Tapestry_EY_ACLN_June06_InSights.pdf.

Collaboration and information sharing at the board level

"Enterprise risk is not purely financial risk," one member said. While risk usually has a financial impact (and would thus be reviewed by the audit committee), it can involve areas of the business overseen by the compensation committee, nominating and governance committee, and the full board itself. At one member's company, to ensure collaboration between committees, *"the compensation committee chair sits on the audit committee, and the audit committee chairs sits on the compensation committee. It allows for ongoing knowledge about the committee activities."* At other companies, the audit and compensation committees *"spend time together on a regular basis. It's important to understand the business and to talk to management [jointly]. That's the basis for assessing risk."* On other boards, enterprise risk committees meet with compensation committees *"once a year jointly. It makes sense – a lot of what the compensation committee is dealing with is related to risk management."*

Scheduling committee meetings continues to be a challenge for many boards. *"Concurrent meetings are a problem,"* one member said. But some members reported that concurrent meetings were a necessity *"due to the travel necessary [for directors] to get to the meeting."* Boards that have concurrent meetings often encourage *"long committee reports [at the full board] – 20 minutes or longer; every item, all of the committee materials."* Even so, one member noted that *"getting the meeting minutes is nothing like sitting at the table." "The problem is the meeting length,"* another member said. *"With the audit and compensation committees, there's not enough time [in the day]."*

A number of boards now have *"consecutive committee meetings, and directors are encouraged to attend them all."* As an additional way to share information, many boards also offer all of the pre-reading materials to all directors, regardless of their committee assignments. One member whose board does so noted that *"while it's optional, more than 85% of the directors choose to get all the committee materials."*

Conclusion

The Southeast Audit Committee Network first spoke about enterprise risk in October 2005. Some things have changed: the primary source of contention is no longer, as *VantagePoint* noted then, "finding the best logical home for ERM efforts, be it the audit committee, the full board, or some other committee, such as governance or a special risk committee."[6] Directors have moved beyond that, in no small part because of the pressures from the credit crisis and the failures of several prominent companies. Enterprise risk has evolved into a collaborative process involving the board and management and utilizing internal and external advisers and resources. Members clearly recognize the importance of a robust enterprise risk program and the necessity of comprehensively and collaboratively balancing risk management with the growth of the enterprise. At the same time, the credit crisis underscores the continuing need for more effective ways to manage risk. The reality that risk will always be present and that its consequences are real leaves members continually searching for more effective risk management practices.

[6] Southeast Audit Committee Network, "Enterprise risk management and the audit committee," *VantagePoint,* October 2005, 6. Available at http://www.tapestrynetworks.com/documents/Tapestry_EY_SEast_ACN_Oct05_Van.pdf.

About this document

The Southeast Audit Committee Network is a select group of audit committee chairs from leading North American 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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