Turning risk into results

How leading companies use risk management to fuel better performance

Ernst & Young
Quality In Everything We Do

Our RISK vision

Results. Improvements. Strategies. Knowledge.

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Introduction

Managing risk for better performance

From Enron and WorldCom to the more recent financial crisis, events of the last decade have fundamentally shifted how organizations think about risk. Companies around the world have made substantial investments in personnel, processes and technology to help mitigate and control business risk. Historically, these risk investments have focused primarily on financial controls and regulatory compliance.

However, these investments have often not addressed more strategic business risk areas. As a result, senior executives may not perceive risk management as strategic to the enterprise. Senior executives also may not have sufficient confidence in their ability to identify and address the risks that could impact the financial performance – or even the viability – of their organization.

A strategic question presents itself: "Do organizations with more mature risk management practices outperform their peers financially?"

Our research and experience tend to suggest "yes!"

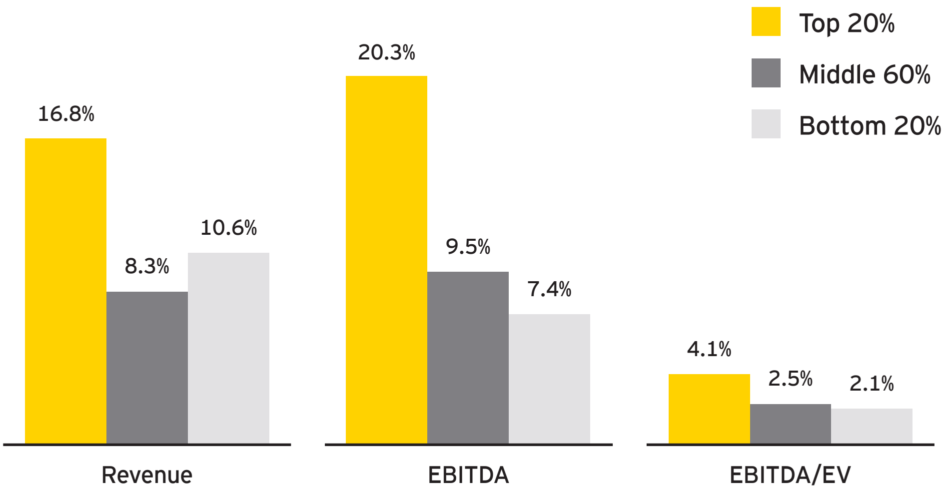
"Our point of view is that companies with more mature risk management practices outperform their peers financially. Our client experience, research and study results strengthen that perspective."

Randall Miller
Global Advisory Risk Leader
Ernst & Young

Mature risk management drives financial results

In our extensive experience with our clients, we see that companies with more mature risk management practices outperform their peers financially. Our research suggests this translates to competitive advantage: we found that companies with more mature risk management practices generated the highest growth in revenue, EBITDA and EBITDA/EV.

Compound annual growth rates 2004–11* by risk maturity level



* 2011 YTD reported as of 18 November 2011.

Six questions for the C-suite

1. What does the concept of "risk management" encompass? Is this the responsibility of select functions or an enterprise-wide responsibility?
2. Does your organization see risk as an opportunity or a threat?
3. Is your approach to risk focused solely on compliance, or does it provide strategic value that improves performance?
4. How confident are you that the organization is managing the risks that really matter?
5. Do you know which risks, if managed well, will increase – or decrease – the value of and results for your organization?
6. How do you know that you are you getting the most from your risk management strategy?

Summary of key findings

Using a global, quantitative survey (based on 576 interviews with companies around the world and a review of more than 2,750 analyst and company reports), we assessed the maturity level of risk management practices and then determined a positive relationship between risk management maturity and financial performance.

We identified the leading risk management practices that differentiated the various maturity levels and organized them into specific risk components.

Our findings suggest that:

- The top-performing companies (from a risk maturity perspective) implemented on average twice as many of the key risk capabilities as those in the lowest-performing group.
- Companies in the top 20% of risk maturity generated three times the level of EBITDA as those in the bottom 20%.
- Financial performance is highly correlated with the level of integration and coordination across risk, control and compliance functions.
- Effectively harnessing technology to support risk management is the greatest weakness or opportunity for most organizations.

Where companies are looking to drive results

Our experience indicates that organizations achieve results from risk in three interrelated ways. Some companies focus on mitigating overall enterprise risk, while others focus on efficiency, reducing the overall cost of controls. Still others look to create value, often through a combination of risk mitigation and cost reduction.

Risk mitigation

In a worst-case scenario, an organization's risks can proliferate at a far faster rate than its ability to provide coverage. Organizations need to have the ability to identify and address key risk areas and the agility to quickly close the gaps through:

- Identifying and understanding the "risks that matter"
- Differentially investing in the risks that are "mission critical" to the organization
- Effectively assessing risks across the business and driving accountability and ownership
- Demonstrating the effectiveness of risk management to investors, analysts and regulators

Cost reduction

For many organizations, finding cost efficiencies in every facet of the organization continues to be critical to survival in this volatile economic environment. Opportunities for cost reduction may include:

- Implementing a new risk operating model to materially improve the cost structure
- Reducing cost of control spend through improved use of automated controls
- Streamlining or eliminating duplicative risk activities
- Improving process efficiency through automated centers, business activities and continuous monitoring

Value creation

Many organizations are looking for ways where risk and control management can help improve business performance. Opportunities may include:

- Achieving superior returns from risk investments
- Accepting and owning the right risks to achieve competitive advantage
- Improving controls around key processes
- Using analytics to optimize the risk portfolio and improve decision-making
- Using risk management savings to fund strategic corporate initiatives

What differentiates top performers?

Our study found that while most organizations perform the basic elements of risk management, the top performers do more. We found specific risk practices that were consistently present in the top performers (i.e., top 20% based on risk maturity) that were not present in the bottom 20%. These risk practices can be organized into the following challenge areas, as depicted in the chart below.

Our study findings suggest that these components are critical to transforming risk and driving better business performance.

The RISK Agenda: research study leading practices

Enhance risk strategy

- Organizations conduct two-way, open communications about risk with external stakeholders.
- Communication is transparent and timely, providing stakeholders with the relevant information that conveys the decisions and values of the organization.
- The board or management committee plays a leading role in defining risk management objectives.
- A common risk framework has been adopted and implemented across the organization.

Embed risk management

- There is a formal method for defining acceptable levels of risk within the organization.
- Stress tests are used to validate risk tolerances.
- Leadership has put in place an effective risk management program.
- Planning and risk reporting cycles are coordinated so that current information about risk issues is incorporated into business planning.

Turning risk into results

Improve controls and processes

- Lines of business have established key risk indicators (KRIs) that predict and model risk assessment.
- Self-assessment and other reporting tools are standardized across the business.
- Controls have been optimized to improve effectiveness, reduce costs and support increased business performance.
- Key risk and control metrics have been established and updated to address impacts on the business.

Optimize risk management functions

- Completion of risk-related training is incorporated into individual performance.
- Risk monitoring and reporting tools are standardized across the organization.
- Integrated technology enables the organization to manage risk and eliminates or prevents redundancy and lack of coverage.
- The reporting system notifies all stakeholders affected by a risk, not just those in the function or area where the risk was identified.

Enable risk management

- Issue tracking, monitoring and reporting are regularly performed using GRC software.
- Risk identification and assessment are regularly performed using GRC software.

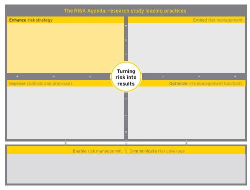
Communicate risk coverage

- Organizations talk about their risk management and control framework in their annual report.
- Organizations provide assurance to their customers and other stakeholders using independent reports (e.g., SOCR).

How leading companies turn risk into results

Companies that succeed in turning risk into results will create competitive advantage through more efficient deployment of scarce resources, better decision-making and reduced exposure to negative events. Now is the time for senior business executives to begin applying a broad "risk lens" to the business.

> **"When it comes to strategy development and execution, it's important for risk to enable business performance — not simply protect the business."**
>
> **Michael Herrinton**
> Americas Advisory Risk Leader
> Ernst & Young LLP



Enhance risk strategy

Effective risk management starts at the top with clarity around risk strategy and governance. It is critical that the proper oversight and accountability exist at the board and executive levels. At the management level, executives need to play a crucial role in assessing and managing risk. An enhanced governance structure, board-level reporting and communications result in improved visibility, accountability and transparency. Additionally, effective reporting and oversight ultimately improve strategic decision-making.

Enhancing risk strategy enables organizations to more effectively anticipate risk. However, even with the most robust preventative risk strategy in place, unforeseen events can still occur that may affect performance. So, while it is imperative to proactively identify strategies that mitigate risk before an event occurs, it is equally important to develop reactive strategies that enable the organization to respond quickly if a risk does materialize.

What top performers are doing right

Our research and study results show that top-performing companies have the following risk management practices in place:

- Two-way open communications about risk occur with external stakeholders.
- Communication is transparent and timely, providing stakeholders with the relevant information that conveys the decisions and values of the organization.
- The board or management committee plays a leading role in defining risk management objectives.
- A common risk framework has been adopted and implemented across the organization.

Case in point

Global 50 company uses strong risk governance to strengthen stakeholder communication

A Global 50 consumer products company wanted to increase transparency and communications with stakeholders. To do this, it began by establishing a Risk Committee at the Board level. Although the board itself acts as a risk committee, no one on the board had been specifically assigned to risk. They then established a Risk Committee at the executive level and brought in a Chief Risk Officer (CRO). And they identified risk champions at the business level.

To establish better external communication, the company developed a governance structure and increased its overall risk agenda by:

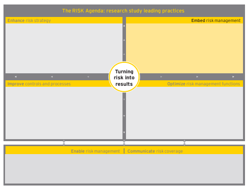
- **Aligning risk to strategy.** This can occur at different levels. The most basic level is to put additional assumptions around the overall strategic plan, which typically looks three to five years out. The organization listed these additional assumptions, and then asked the three basic questions to develop a risk profile and identify the strategic risks: 1) What has to go right to achieve our strategy? 2) What could go wrong? and 3) How would we know?
- **Embedding risk principles into the business unit planning cycle.** The organization asked the same three questions of the business units as they put together their 12-month forecasts to identify the operational risks.

Developing a risk governance structure also included establishing the organization's risk appetite, defining the risk universe, determining how the business would measure risk and establishing enabling technology to help manage risk.

Asking the three questions at both the strategic and operational levels enabled the organization to document 80% of the risks that have an impact on performance. Establishing a risk governance structure, identifying roles and responsibilities, and developing a mandate and scope for each risk committee increased internal stakeholder communication.

By identifying the strategic and operational risks that were impacting the organization's performance, and by establishing a coordinated approach to risk across the enterprise, this consumer products company was able to communicate its risk strategy confidently and openly with external stakeholders, strengthening relationships and building greater trust in the market.

Embed risk management



Risk is inherent in every business, but organizations that embed risk management practices into business planning and performance management are more likely to achieve strategic and operational objectives. Top-performing companies understand that risk needs to be embedded as part of an organization's DNA.

Several years ago, many organizations were focused on mitigating risks, controlling costs, keeping the business out of trouble and protecting the brand. Today, more and more organizations are focused on developing risk management strategies that enable the business. For the first time, we are clearly seeing organizations identify the links among business, technology and risk strategies – how they all fit together.

What top performers are doing right

Our research and study results show that top-performing companies have the following risk management practices in place:

- There is a formal method for defining acceptable risk thresholds within the organization.
- Stress tests are used to validate risk tolerances.
- Leadership has put in place an effective risk management program.
- Planning and risk reporting cycles are coordinated so that current information about risk issues is incorporated into business planning.

Case in point

The value of good risk management

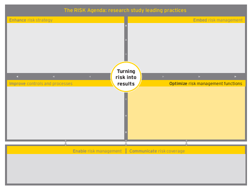
"We don't understand the value of our risk initiatives," complained a company executive team. "They are costing us a lot of money, implementation is so slow that it is hampering our agility and there's confusion at the board level in terms of the reports they receive. We just can't get a handle on what everyone is doing and how well they are doing it." Why? Because risk was not embedded into the business, roles and responsibilities were not clearly identified and there was no coordination among risk functions. As a result, the executive team had no visibility into the organization's health from a risk perspective.

To resolve the issue, the client set about to embed risk management into the business by:

- **Developing a value tree.** The organization had already identified the top 10 to 15 risks. It had also identified the top five performance indicators. However, it did not understand the link between the two. The value tree helped the organization link the top five performance indicators to the top risks.
- **Linking risk to the strategic planning cycle.** The organization had already identified its top risks, but it needed to take the next step and link those risks to its strategic planning cycle.
- **Inserting risk principles into the business planning cycle.** By linking risk to the business planning cycle, the organization was able to prioritize and link the key risks to its operations.
- **Reviewing the capital agenda.** The organization had spent a great deal of time reducing operational spend, but it had not addressed the capital spend. The goal was to achieve efficiencies of 15% to 20%. The organization reviewed how it allocated capital.
- **Embedding risk principles into M&A.** The organization was growing through M&A and expansion into emerging markets. To maximize the strategic value of these initiatives, the CRO embedded risk principles into M&A and emerging market activities.

The organization also had to shift the General Counsel's approach to risk. The General Counsel believed that risk was something that shouldn't be documented – that once it was written down it would become a liability. By creating a direct link between risk and 10-K statements, the organization was able to get much needed buy-in from the General Counsel.

Optimize risk management functions



As an organization changes and grows, its risk, control and compliance activities often become fragmented, siloed, independent and misaligned. This has an impact on both the governance oversight and the business itself. Often, there are multiple communications to management and the board that overlap and cause confusion. And, a lack of coordination among functions can increase costs and fatigue on the business.

By taking the following steps, an organization can reduce its risk burden (overlap and redundancy), lower its total costs, expand coverage and drive efficiency:

- **Align mandate and scope.** Aligning monitoring and control functions to the risks that matter most to the business can optimize the value of the organization's risk management functions.
- **Coordinate infrastructure and people.** A continual evaluation of capability levels and gaps, consistency of roles and responsibilities, and investment in skills development promotes efficiency.
- **Use consistent methods and practices.** Applying a disciplined approach to risk management across the organization will help risk functions "speak the same language" when reporting to the board.
- **Implement common information and technology.** Sharing information and technology tools is critical to aligning key business risks and creating visibility to risk management activities throughout the organization.

What top performers are doing right

Our research and study results show that top-performing companies have the following risk management practices in place:

- Completion of risk-related training is incorporated into individual performance.
- Risk monitoring and reporting tools are standardized across the organization.
- Integrated technology enables the organization to manage risk and eliminates or prevents redundancy and lack of coverage.
- Overlap and duplication of risk activities have been identified and are being addressed.

"Many executives have no idea what the return on their risk investment is. If they say that their return is neutral, I tell them that I don't think that's good enough."

Jonathan Blackmore
Advisory Risk Partner
Europe, Middle East, India and Africa
Ernst & Young

Case in point

A leading pharmaceuticals company creates action plan for self-funding risk initiatives

Tired of the state of their organization's risk environment, senior executives of a pharmaceutical company gathered the leaders of each risk function — Internal Audit, SOX, Legal and Regulatory, Compliance and ERM. The executives then listed a series of issues relative to overall risk management:

- Confusion around risk coverage at the Board level
- Burden on the business units
- Lack of coordination and communication in the development of more than 13 separate risk assessments
- Development of seven different risk calendars
- Timing of risk activities that didn't align to the "rhythm of the business"
- Gaps in addressing key risks
- Overlaps in roles and responsibilities within risk functions

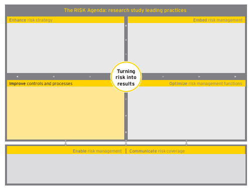
They then gave their risk leaders three days to identify as a team their current state, establish a future state and develop an action plan with a ROI that would self-fund all future risk initiatives. Accompanying this challenge was an ultimatum: if they couldn't come back to the executive team with a viable solution, they would be replaced with risk leaders who could. Individually, the executive team indicated that each risk leader would receive top marks for their current efforts. However, because each spent so much time building silos rather than breaking them down, as a group the risk leaders received a failing grade. The organization had reengineered finance, supply chain and plant operations. It was time to reengineer risk management.

Knowing that they couldn't tackle everything at once, the risk team put together a business plan that produced quick fixes to simple issues and generated early wins. In particular, the risk team focused on six specific actions:

1. Creating a single planning calendar that aligned with the business cycle
2. Reviewing mandate, scope and processes for each function to identify gaps and overlaps that they needed to address
3. Coordinating risk assessments that met the needs of most of the risk functions, thereby reducing the number of risk assessments from 13 to 2
4. Adopting a common framework, nomenclature and risk universe
5. Developing risk mitigation strategies
6. Using common technology tools to collect information into a single repository that all risk functions could access

In addition to these six actions, the risk team also focused on creating a single view of risk that broke down the silos, improving communication and coordination.

As a result of their efforts, the risk team was able to create a single view of risk that focused on the risks that mattered most, placed less pressure on the business, created greater agility and responsiveness to risk-related issues, and was self-funding.



Improve controls and processes

Although organizations understand the value of building controls and processes that focus on risk, many organizations still struggle to create optimal control environments that balance cost with risk.

By optimizing controls around key business processes, harnessing automated versus manual controls, and continuously monitoring critical controls and KPIs, organizations can improve performance and reduce the cost of controls spend.

What top performers are doing right

Our research and study results show that top-performing companies have the following risk management practices in place:

- Lines of business have established key risk indicators (KRIs) that predict and model risk assessment.
- Self-assessment and other reporting tools are standardized across the business.
- Controls have been optimized to improve effectiveness, reduce costs and support increased business performance.
- Key risk metrics have been established at the business level.

Case in point

Global 200 consumer products company streamlines controls and costs

A Global 200 consumer products company determined that its cost of control was too high. The company's over-controlled environment was hindering Finance's ability to effectively respond to changes in the competitive landscape. The company wanted to reduce its cost of controls to help drive a 50% reduction in its €100 million controls costs spend.

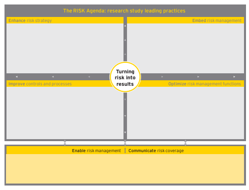
To achieve its goal, the consumer products company implemented three big ideas:

1. Establish a global Controls Center of Excellence (CCoE) that designs and mandates a common set of controls
2. Embrace controls developed by the CCoE by using standard SAP prevent controls
3. Use embedded controls in SAP to provide assurance

The global CCoE enabled the company to automate more than 90% of its prevent controls and decommission duplicate and ineffective legacy controls. By using SAP, the company minimized the use of manual detect controls, driving a more efficient, effective and paperless controls environment. Finally, by leveraging the embedded controls in SAP, as well as analytic tools and dashboards, management was able to receive real-time, transparent assurance that the control environment was working effectively.

> "Consolidating multiple sets of controls and compliance requirements into a single framework enabled by GRC technology removes duplication and simplifies compliance — sometimes reducing the effort by half."

Bernie Wedge
Americas IT Risk and Assurance Leader
Ernst & Young LLP



Enable risk management, communicate risk coverage

Making a move from being risk-averse to risk-ready may require a significant shift. Organizations will want an executive champion to lead it, as well as tone-from-the-top support and executives who lead by example. Ultimately, risk management is about changing the culture of the business. It is about changing the lens through which leaders view the decisions they make. To help shift the perspective within an organization, executives may want to ask the following questions:

- Where are we as a business?
- What is our appetite for change?
- What kind of organization are we?

The answers to these questions provide the basis upon which risk management decisions can be made.

As part of any change management effort, organizations will also want to communicate openly and often with all stakeholders. For greater assurance, organizations should provide stakeholders with independent, third-party verification.

Organizations also need to leverage their technology for maximum benefit. This does not mean risk initiatives should be technology-led. Rather, technology should be an enabler of change. Current GRC tools have the ability to enable an entire risk agenda. This can include minimizing redundancies, improving risk coverage and automating controls. However, organizations need to ensure that any risk-focused IT strategy aligns with broader risk and business strategies.

What top performers are doing right

Our research and study results show that top-performing companies have the following risk management practices in place:

- Issue tracking, monitoring and reporting are regularly performed using GRC software.
- Risk dashboards are automated and include governance, risk and compliance indicators.
- Risk identification and assessment are regularly performed using GRC software.

> "Now more than ever, organizations need to have a comprehensive and coordinated governance, risk and compliance management approach. Technology can play an important role in enabling change and in finding the right balance among risk, cost and value across the enterprise."

Paul van Kessel
Global IT Risk and Assurance Leader
Ernst & Young

Conclusion

Embracing risk for better business performance

Our research findings and study results support Ernst & Young's experience with our clients that turning risk into results requires a multifaceted approach:

- **Enhance risk strategy.** Effective risk management starts at the top with effective strategy and governance. It is critical that the proper oversight and accountability exist at the board and executive levels. Of equal importance is the need for ownership of risk throughout the organization. At the management level, executives need to play a crucial role in assessing and managing risk.
- **Embed risk management.** Risk is inherent in every business, but organizations that embed risk management practices into business planning and performance management are more likely to achieve strategic and operational objectives. Conducting an enterprise risk assessment can help to prioritize and identify opportunities for improvement.
- **Optimize risk management functions.** By aligning and coordinating risk activities across all risk and compliance functions, organizations can reduce their risk burden (overlap and redundancy), lower their total costs, expand coverage and drive efficiency.
- **Improve controls and processes.** By optimizing controls around key business processes, harnessing automated versus manual controls and continuously monitoring critical controls and KPIs, organizations can improve performance and reduce the cost of controls spend.
- **Enable risk management, communicate risk coverage.** Moving your organization from being risk-averse to risk-ready will require an executive champion to lead it, as well as tone-from-the-top support and executives who lead by example. You will want to communicate openly and often with all stakeholders, provide third-party assurance and leverage technology for maximum benefit.

Creating competitive advantage

Both our research and our deep experience serving companies around the world indicate that companies that succeed in turning risk into results will create competitive advantage. This is the time for senior business executives to evaluate existing risk investments and consider how to move beyond compliance to addressing the issues around strategic business value — and the approach outlined in this study can serve as an invaluable road map.

Risk is now becoming the fourth dimension of business. People were the first dimension. Process became the second dimension during the height of the manufacturing era. Evolving technology formed the third dimension. Embedding risk as the fourth dimension of business has the potential to fundamentally transform how organizations connect risk to reward.

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The relationship between risk and performance improvement is an increasingly complex and central business challenge, with business performance directly connected to the recognition and effective management of risk. Whether your focus is on business transformation or sustaining achievement, having the right advisors on your side can make all the difference. Our 20,000 advisory professionals form one of the broadest global advisory networks of any professional organization, delivering seasoned multidisciplinary teams that work with our clients to deliver a powerful and superior client experience. We use proven, integrated methodologies to help you achieve your strategic priorities and make improvements that are sustainable for the longer term. We understand that to achieve your potential as an organization you require services that respond to your specific issues, so we bring our broad sector experience and deep subject-matter knowledge to bear in a proactive and objective way. Above all, we are committed to measuring the gains and identifying where the strategy is delivering the value your business needs. It's how Ernst & Young makes a difference.

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