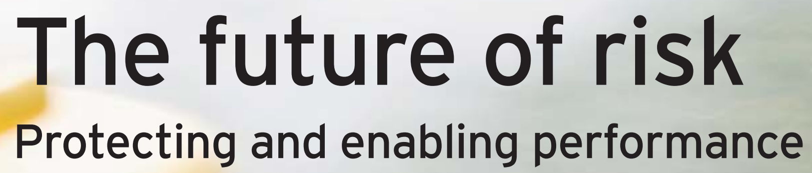


The future of risk

Protecting and enabling performance

Ernst & Young

Quality In Everything We Do

Contents

Introduction 1
The risk landscape is changing 2
Maturing of risk management practices 4
Recognizing opportunities 6
Focus areas for improvement 8
An improved future state of risk 10
Summary 13
Survey approach 14
Contacts 16

Introduction

Albeit painful, progress ultimately results from crisis. The current downturn is causing companies to challenge their risk management processes and ask how they can further improve their risk management efforts. Against this backdrop, we conducted a survey to provide a snapshot of the current risk environment and to understand organizational attitudes toward enterprise risk management. We were also interested in understanding how recent events have impacted approaches to risk management and organizations' abilities to identify and manage different types of risk. Never has there been a more critical time to define a path forward for the "future of risk."

We believe that the recent economic challenges were, in part, more difficult to predict and manage due to the increasing complexity of risk management processes. Over the past few decades, the number of risk management functions has grown to the point where most large companies have seven or more separate risk functions — not counting their independent financial auditor. This has created inefficiencies and resulted in a degree of fatigue on the business. As the number of risk functions increases, coordination becomes more difficult and often results in coverage gaps and overlapping responsibilities. The demands and various reporting requirements placed on the business by these risk functions can become significant and burdensome. The number of risk functions and the various communications from these functions can be a challenge for executives and the board of directors to manage and understand.

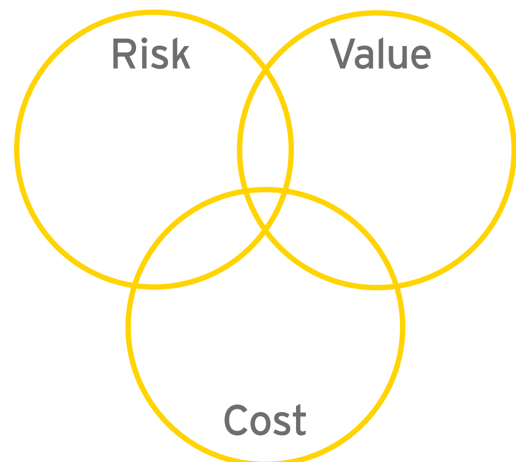
As complexity has increased, so has company spending on risk management. Based on a previous survey we conducted last year of Fortune 1000 companies, we estimate that the average company spends about 4% of revenue on risk management activities.

Considering the events of the past 12 months, it is not surprising that 96% of our recent survey respondents believe that their risk management programs could be improved. Furthermore, only 1% of companies intend to reduce their risk management resources. Given the current cost-conscious mentality, the fact that nearly all companies want to improve their risk management efforts and intend to maintain or increase their current levels of investment underscores the growing awareness of the value of sound risk management.

Moreover, 46% agreed that committing more resources to risk management would help to create a competitive advantage. Clearly, organizations recognize the importance of risk management. Leading organizations acknowledge that risk management is more than simply protecting existing assets; it is also about enabling performance to create future value.

However, the reality is that most risk functions will be asked to do more with the same or limited additional resources. There is a strong drive to improve risk coverage through better use of existing resources and to deliver more value from their respective functions. The challenge for most organizations will be to find increased efficiencies in the way their risk management functions operate and define the improvements that create the greatest value. We believe the answer to these challenges can be found by carefully considering how best to balance risk, cost and value across the enterprise. Companies that effectively address this challenge are more likely to outperform their competitors.

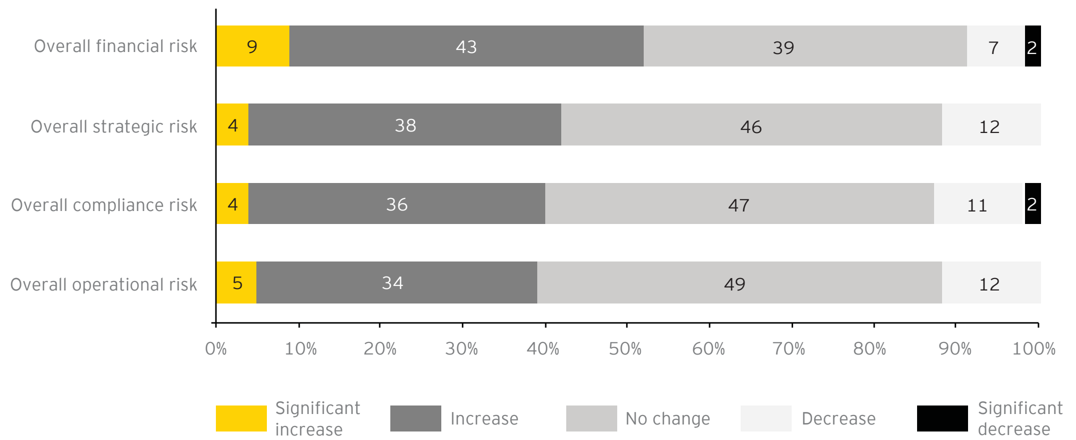
We believe the answer to these challenges can be found by carefully considering how to balance risk, cost and value across the enterprise.



The risk landscape is changing

Risk management priorities continue to shift in the wake of global economic challenges. Some organizations have been faced with financial crisis. In response, they are intensifying efforts to manage costs and improve performance. Fifty-two percent of our respondents indicated that their financial risks have increased during the past 12 months; 42% said that strategic risk has increased; 40% believe their compliance risks have increased; and 39% indicated their operational risks have increased. Very few organizations indicated a decrease in any of the four risk areas. Eighteen months ago, few organizations would have placed financial risk at the top of their list or anticipated that it would increase at the current pace. The question organizations face now is, "Do our risk management efforts help us understand which risks will emerge in the next 12 months?"

Over the past 12 months how has risk increased or decreased for your organization in the following risk areas?



Organizations have recently been criticized for their limited views on possible sources of risk, their inability to anticipate the impact of risks or their slowness to respond to risks. We asked respondents to indicate how effective their organizations are at managing each of four key risk areas: financial, strategic, compliance and operational. Respondents were more comfortable with their effectiveness in managing compliance and financial risks than they were with their capabilities in managing strategic and operational risks.

We believe this reflects a historical focus on compliance and financial risks, which we expected based on traditional investments in internal control and risk management. This is further validated by our experience, which indicates that companies do not have a comprehensive plan to identify and address all key risks across their organization. We also find it is common for companies to have a higher level of confidence in their ability to effectively manage risk than their risk activities would suggest.

Leading organizations have expanded the scope of their risk assessment efforts by scanning the broader business environment to identify emerging risks. Through more comprehensive risk assessments, these organizations are examining their entire value chain — including suppliers, customers, competitors, business partners and key stakeholders — to define emerging risks and identify opportunities.

Key risk areas

Financial risks

- Accounting and reporting (e.g., accounting, reporting, internal controls)
- Market (e.g., interest rate, currency)
- Liquidity and credit (e.g., cash management, hedging)
- Tax (e.g., tax strategy and planning, indirect taxes, transfer pricing)
- Capital structure (e.g., debt, equity, options)

Strategic risks

- Planning and resource allocation (e.g., organization structure, strategy, budgeting)
- Communications and investor relations (e.g., media, investor and employee communications)
- Major initiatives and capital programs (e.g., vision, planning, execution, monitoring)
- Competitive market dynamics (e.g., competitive pricing)
- Mergers, acquisitions and divestitures (e.g., valuation, due diligence, integration)
- Macro-market dynamics (e.g., economic, social, political)

Compliance risks

- Governance (e.g., board, tone at the top)
- Regulatory (e.g., labor, safety, trade/customs)
- Legal (e.g., contracts, intellectual property)
- Code of conduct (e.g., ethics, fraud)

Operational risks

- Information technology (e.g., IT management, security, availability)
- Physical assets (e.g., real estate; property, plant and equipment)
- Sales and marketing (e.g., advertising, pricing, customer support)
- People (e.g., recruiting, retention, development)
- Research and development (e.g., market research, product design and development, product testing)
- Supply chain (e.g., planning, inventory, distribution)
- Hazards (e.g., natural events, terrorist acts)

Maturing of risk management practices

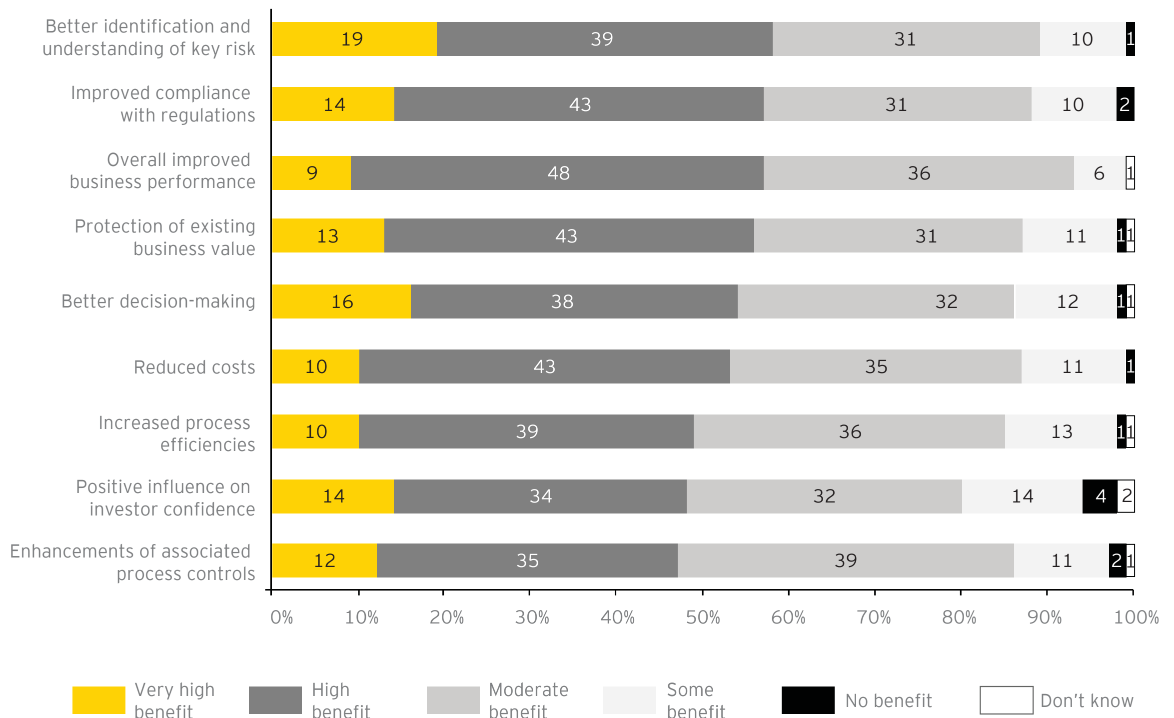
In general, responses suggest that there has been an advancement of risk management efforts over the past several years. A majority indicated that their organizations have:

- Aligned their risk management efforts with business strategy and objectives (80%)
- Leveraged information technology to support the company's risk efforts (67%)
- Aligned their risk management efforts with performance management (67%)
- Embedded risk and control activities throughout the organization (65%)

Recent events have forced a maturing and advancement of risk management, and many organizations can take pride in the progress they have made. However, this sense of confidence based on "how far we've come" should not prevent organizations from recognizing how much farther there is to go and continuing to make improvements in the way they manage risk. Now is not the time to become complacent. Leading organizations recognize the continuing opportunity to improve their risk assessment, enhance monitoring, reduce costs, better integrate information technology and reduce organizational fatigue — and the competitive advantage that can be achieved as a result.

In our survey results, respondents indicated that risk management activities provide significant benefits. In addition to "better identification and understanding of key risk areas," the next most common responses were "improved compliance with regulations," "overall improved business performance," "protection of existing business value," "better decision-making" and "reduced costs."

How significant are the benefits that your risk and control activities currently provide your organization?



Case study

Driving value through reduced cost and improved risk coverage

A US Fortune 500 consumer products company wanted to improve its risk coverage and reduce costs. In addition, it wanted its risk activities to support its business objectives of growing its business in Asia, Europe and Latin America in a profitable and cost-effective manner. The company selected Ernst & Young as its outsourced internal audit provider.

One of the primary objectives was to reduce the company's risk spend by focusing on the most important risks and becoming more efficient in the coordination of its activities. This rethinking of how risk is managed has improved the company's focus on higher-risk and higher-value areas. One example of this new thinking is how the company has changed its process audits:

- In the past, the company performed process audits on a rotational basis among the various countries of operation. The common processes for review include inventory management, procure-to-pay and order to cash. A sampling method was used to review selected transactions within each process. A typical audit would include a team of three to four people over several weeks, incurring approximately 400 – 500 hours plus travel costs.
- Using a new audit approach incorporating data analytics, "desktop audits" are performed on a more frequent basis by analyzing every transaction for a period of time, typically a quarter, rather than reviewing a small sample. Based on the analysis, the team identifies anomalies within the process and may further examine select transactions that are unusual. This technique helps to identify very specific risk areas that may require further exploration. In select cases, an on-site audit may be required to further identify the root cause of an issue of concern. However, at that point the audit is highly focused and can typically be performed by a local Ernst & Young professional in less time and without incurring travel expenses.

This new approach has accomplished several important objectives: Through the use of data analytics in upfront planning, the scope of the audits is more precise and focused on the highest-risk areas. As a result, the average time for a process audit has been reduced by more than half. Audit-related travel costs, which were significant in the past, have been reduced. These cost savings have allowed the company to improve its risk coverage by performing the work more frequently, rather than annually, and by covering more transactions. In addition, some of these savings will allow the company to refocus more of its efforts on improving risk coverage. For example, the company can now spend time focusing on other areas of strategic importance such as capital project management, data privacy, IFRS conversion and working capital improvements.

This audit approach allows the company to benefit from greater risk coverage over daily activities through the use of data analytics and allows additional time to be spent on special projects and other higher-risk areas. Travel costs have been reduced greatly as a result of the availability of Ernst & Young professionals in every country where the company operates.

Recognizing opportunities

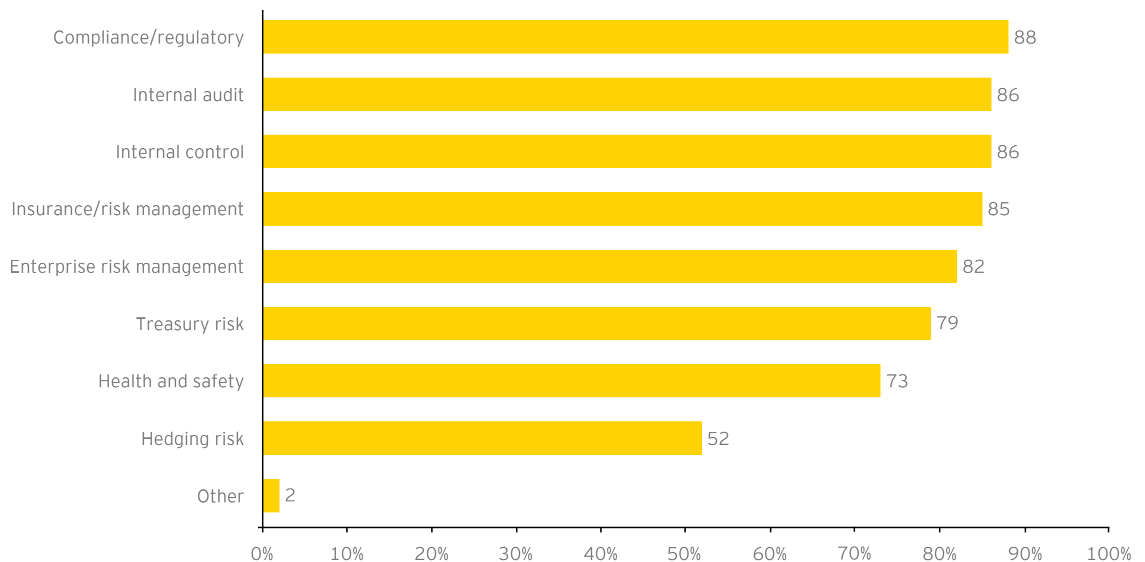
It may be convenient to blame the current economic environment on events that began in the real estate and financial sectors, but risk management efforts in other sectors were far from bulletproof. In fact, as early as November 2007, "global financial shocks" were predicted to be the second most significant of the top risks facing all business in 2008. "The failure of one or more financial institutions could turn into a systemic failure in the year ahead."[1] Many nonfinancial organizations didn't perceive a financial meltdown as a risk to their business or understand the potential impact such a risk would have. As a result, companies have experienced the most challenging risk environment in recent history.

More than ever, organizations need to have a comprehensive and coordinated risk management approach with strong executive oversight and board of director governance. Risk management groups within an organization often exist in silos that may be uncoordinated and disconnected from the wider business strategy. As a result, risks identified in one area may not be communicated or recognized by another. Moreover, different areas within an organization may have different views on the severity or importance of certain risks.

The separate groups frequently perform disparate activities and use different approaches to manage risk, which results in duplication of effort and potential gaps in risk coverage.

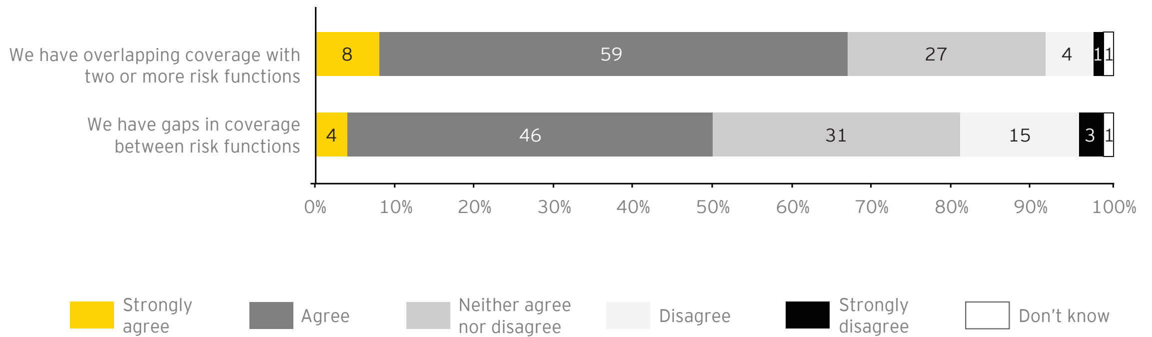
- Seventy-three percent of respondents indicated they have seven or more risk functions.
- Sixty-seven percent had overlapping coverage with two or more risk functions.
- Fifty percent reported gaps in coverage between risk functions.

What risk functions exist within your organization?



1 Ernst & Young (November 2007), *Strategic Business Risk 2008: the top 10 risks for business*

Please indicate whether you agree or disagree with the following statements:

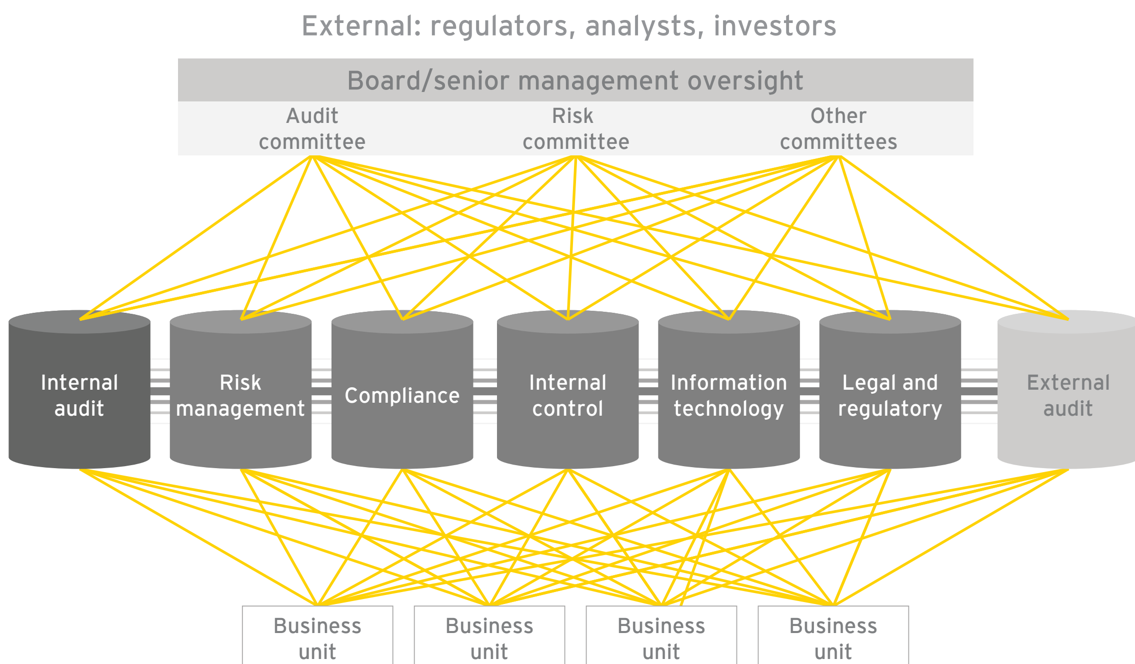


These results are not surprising; it is common for organizations to have complex risk management efforts that are often not well coordinated. A typical organization's current-state risk functions might look something like the diagram below.

In many organizations, numerous risk, control and compliance activities commonly exist. These activities, depicted by the silos in the center of the diagram, are often fragmented, independent or misaligned. This is reflected by the multiple lines of communication in the diagram.

This has an impact on both the governance oversight and the business itself. In this situation, there commonly are multiple communications to management and the board, and these communications may overlap or cause confusion. Toward the bottom of the diagram, we also see the impact on the business itself represented by the multiple lines from the risk, control and compliance functions to the various business units. These demands for information and complex communications can result in increased costs and fatigue on the business.

In a situation such as this, the opportunity to improve is significant.



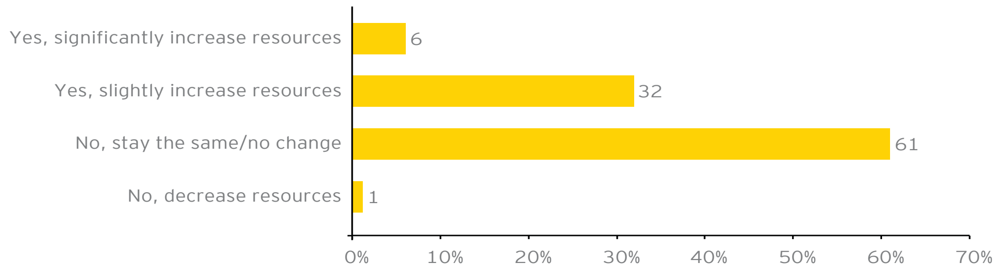
Focus areas for improvement

Despite the economic downturn, nearly four out of 10 (38%) survey respondents intend to increase their resources — people, management attention or financial resources — to strengthen their risk management capabilities; another 61% plan to maintain their current risk investments. Of the organizations that plan to commit more resources, the top areas of focus were: better aligning risk management to business objectives; improving the risk assessment process; redefining risk ownership roles, processes and structure; and improving coordination among multiple risk management functions. Other key areas of focus are elements that further improve coordination, alignment and efficiencies.

An emerging trend among organizations seeking efficiencies is the use of strategic "co-sourcing arrangements" or "outsourcing" for key risk management activities. This allows a company to build upon its existing capabilities, while supplementing with specialized personnel with hard-to-find competencies. This approach encourages management to critically identify areas where an internal solution may not be economically feasible or as effective. Common specialty areas include skills such as risk assessment, data analytics, emerging market risk, fraud, IT security, operational risks and continuous monitoring.

This trend is evidenced by the 39% of respondents who identified outsourcing or offshoring certain risk functions as an important step to improve their risk function. We have found that many leading organizations consider this option a means to accelerate the realization of improvement to their overall risk coverage, increase value to their operations and reduce costs.

Do you plan to commit more resources to strengthen your risk management capabilities in the next 12 to 24 months?



If you plan to commit more resources to strengthen your risk management capabilities, what will be your areas of focus?

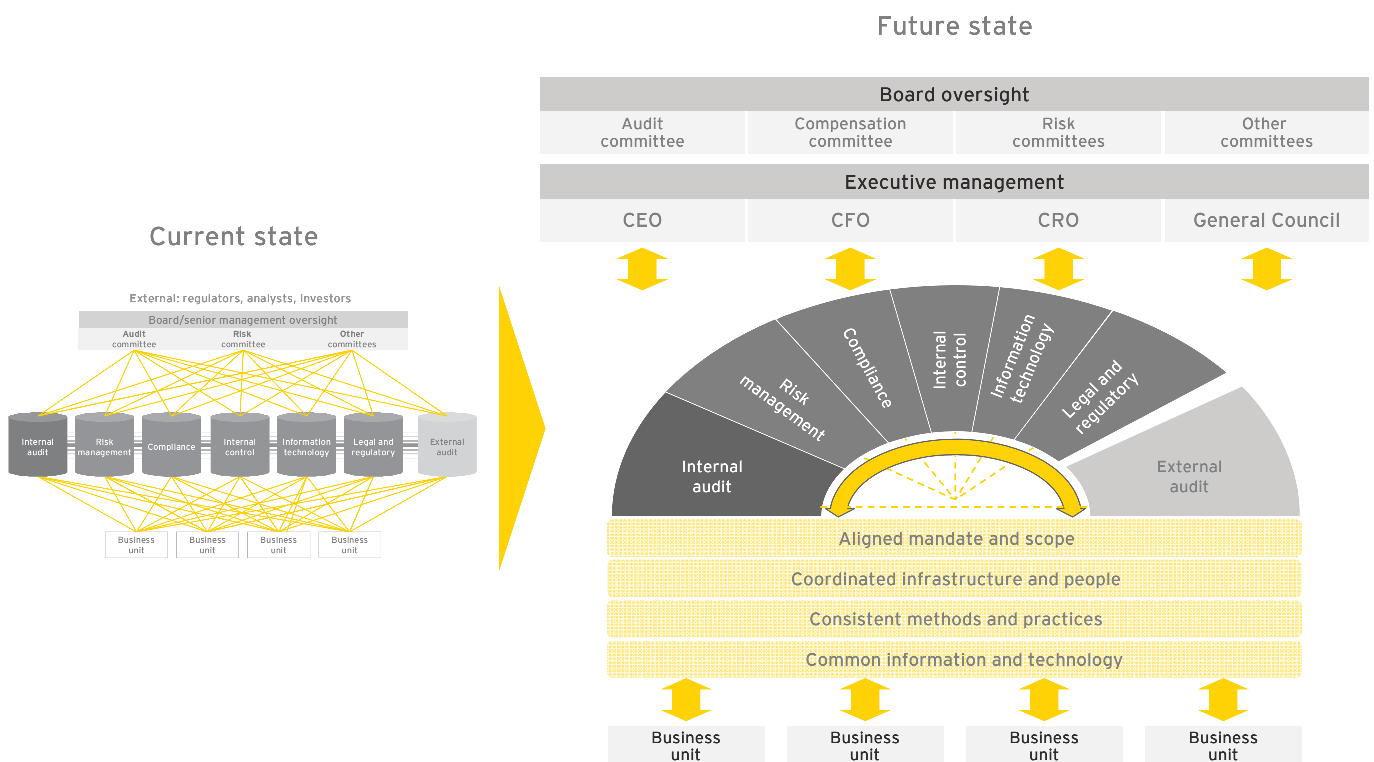
An improved future state of risk

In our experience, as organizations strive to improve their risk management efforts and related risk functions, they aspire toward the alignment and coordination in their risk and control activities as depicted by the future state diagram below.

Compare this diagram with the earlier current state diagram. The interactions between the various risk management functions, the board and executive management are more efficient. There are also fewer competing requests and less fatigue on the business units below. The key to making this approach work lies between the risk and control functions and the business units: an aligned mandate and scope, coordinated infrastructure and people, consistent methods and practices, and common information and technology.

- **Aligned mandate and scope** enables risk management to provide value to the business by aligning monitoring and control functions to those risks that matter most to the business and by addressing those areas of risk with people who have strongest knowledge of the subject.
- **Coordinated infrastructure and people** promotes efficient and effective risk management through a continual evaluation of capability levels and gaps, consistency of roles and responsibilities, and investments in skills development.
- **Consistent methods and practices** helps apply a structured and disciplined approach to key aspects of risk management across the organization including: identification and assessment of risk, continual improvement of risk mitigation efforts, risk monitoring and escalation protocols, and risk validation and reporting.
- **Common information and technology** enhances business decision making over a wide range of business areas by leveraging IT to consistently share information regarding key business risks and risk management activities throughout the organization.

For such an approach to be successful, companies should address weaknesses exposed in this survey through improved alignment and coordination, improved standardization, leveraged technology and improved communications. In doing so, the result will be movement toward leading practices.



Case study

Meeting business objectives through an integrated risk and control framework

Transnet is a large rail freight transportation and logistics company employing approximately 50,000 people. In 2005, Transnet, which forms the logistics backbone of South Africa, developed a turnaround strategy to become a world-class organization. In order to accomplish this, Transnet identified the need to make fundamental changes to its governance and risk management practices, in addition to a number of other key areas of focus.

The leadership team recognized the importance of developing a risk and control framework to enable the organization to meet its corporate strategy, business objectives and responsibilities to stakeholders, while at the same time complying with regulatory requirements.

To help it achieve its vision, Transnet outsourced its internal audit function to Ernst & Young. According to Chris Wells (Chief Financial Officer), "The outsourcing of the internal audit function was an essential part of our turnaround strategy and has been a critical component in improving our control environment as we strive to become a world-class organization. This arrangement has given us access to experience that has enhanced our governance, risk and control activities and supported our drive to improve performance."

Transnet and Ernst & Young have worked toward a simple proposition: An organization that has developed and implemented a sound control framework will have a better likelihood of achieving and sustaining its business objectives. The approach to achieving this is clear:

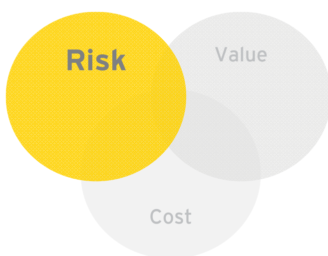
- Understand the linkage between stakeholder requirements, business objectives, policies, procedures and processes
- Recognize that risk management requires the identification, management and monitoring of all risks, (both explicit and implicit) not just those risks that pose an immediate threat
- Define and embed controls into all business processes
- Clearly define roles and responsibilities in relation to controls
- Make certain that monitoring functions and processes provide ongoing visibility and enhance sustainability

In order for the framework to function effectively, Transnet required a combination of the right oversight, right people and standard methods and processes to deliver against its objectives and have instituted several key changes including:

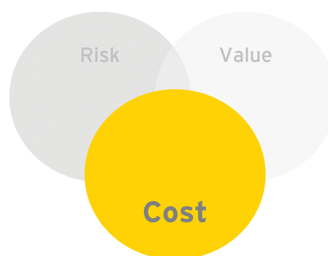
- **Governance:** A clear and highly visible commitment of the leadership to the importance of effective controls to meet business objectives.
- **People:** A culture across the organization that has enhanced the control consciousness of the business.
- **Methods and practices:** Conducting top-down risk assessments, identifying and improving critical controls in relation to both financial and operational processes, enhancing systematic and automated process level controls, introducing control self assessments in a comprehensive manner across the organization and embarking on initiatives in continuous controls monitoring.

The improvements to Transnet's risk and control coverage are apparent and measurable. In the four years since outsourcing the internal audit function to Ernst & Young, Transnet has strengthened its governance structures and risk management processes substantially, and going forward will shift the focus from financial processes and controls towards enhancing the operational processes and controls. Ernst & Young has played a lead role in developing and implementing the control framework and has elevated the role of internal audit from the backroom to the boardroom. This has enabled the function to provide strategic insights aimed at supporting the business transformation process and ultimately improving organizational performance.

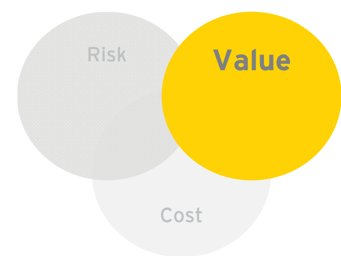
Questions to consider for balancing risk, cost and value



- Do we understand the risks that our company faces?
- Do we know our key risks?
- Do we have effective risk reporting for executive management and the board?
- Are we accepting the right level of risk?
- Do we know if our risks are being properly managed?
- Do we have a comprehensive risk framework in place?



- Are we focused on the risks that matter?
- Do we have duplicative or overlapping risk functions?
- Are we leveraging automated controls versus manual controls?
- Do we have the right mix of skills at the right cost?
- Have we optimized the use of technology to manage risk?
- Can we use alternative sourcing strategies to reduce costs?



- Are the risks we take aligned to our business strategies and objectives?
- Are we getting the right return on our risk investment?
- Are we getting process improvement ideas?
- Are we taking the right risks to achieve competitive advantage?
- Is risk management slowing me down or helping me go faster?

Summary

Risk management has grown increasingly complex over the years, prompting organizations to increase the size, magnitude and reach of their risk management functions. However, an increase in risk management activities does not always correlate to more effective risk management. Recent events have revealed this vulnerability and provided a much needed "wake-up call." Many organizations had committed significant resources and investment in risk management but had not worked to connect their processes. Kingdoms or silos were developed, but the levels of interaction, shared reporting, data exchange and coordination was minimal.

While there has been a maturing of risk management, there is still considerable opportunity for improvement. Organizations need to constantly challenge their approach to risk management. This is especially true now, when risk functions are being asked to do more with the same — or limited additional — resources. More than ever, organizations need to rethink their approach to risk management in order to balance risk, cost and value. Our research shows the most commonly identified areas for improvement are:

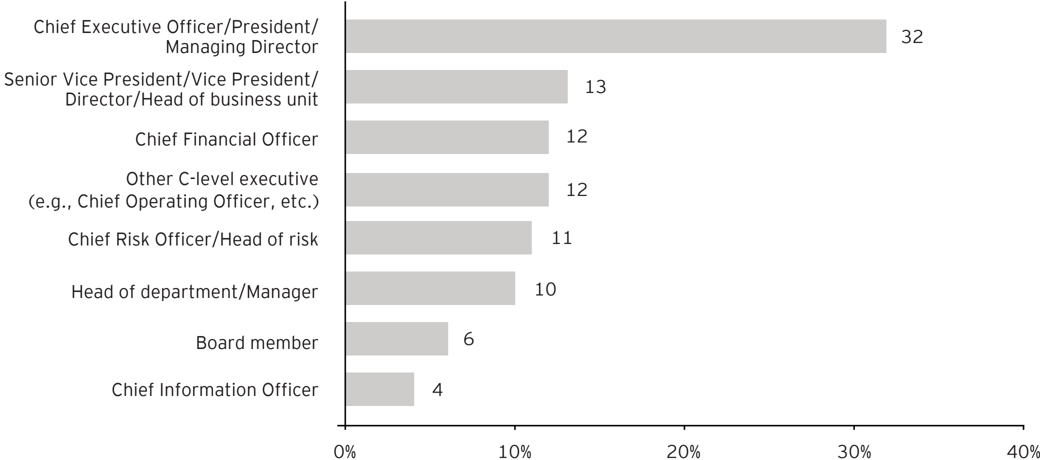
- Improving the risk assessment approach to better anticipate, identify and understand risks
- Aligning risk management focus with business objectives to drive greater value and focus on the risks most likely to affect the business
- Enhancing coordination of risk and control groups to achieve greater efficiencies and eliminate redundancies, duplication and gaps among risk activities

Organizations that improve their risk management activities will not only provide better protection for their businesses, but also improve their business performance, improve their decision-making and, ultimately, increase their competitive advantage.

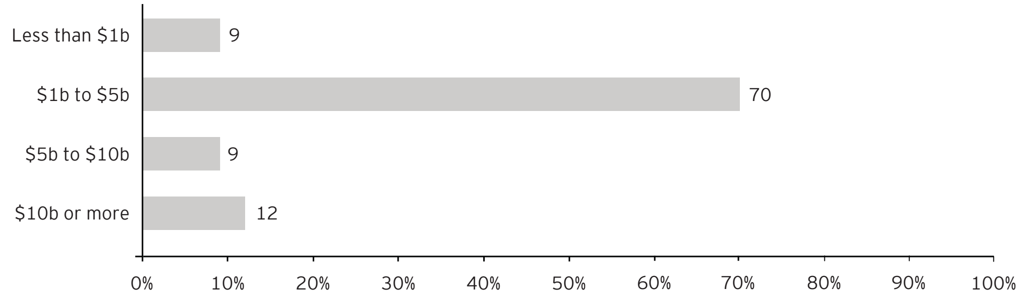
Survey approach

For this study, the Economist Intelligence Unit surveyed 507 executives from across the world. The research was conducted in June and July 2009.

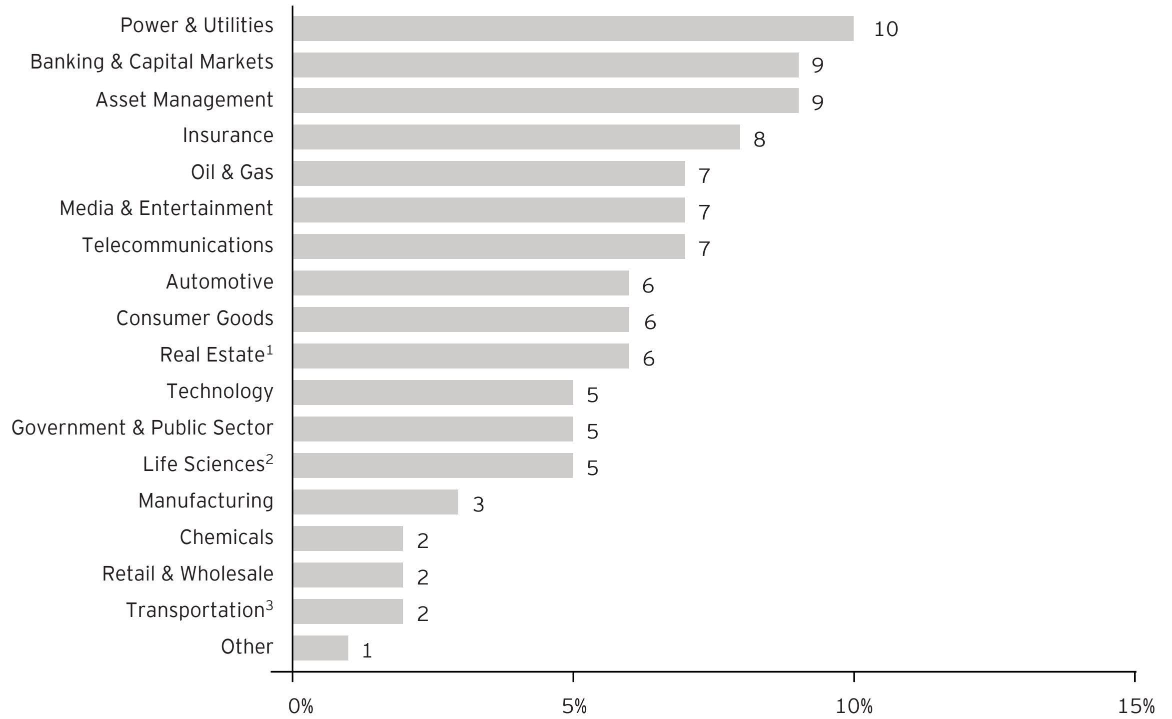
What is your job title?



What are your company's annual global revenues?
(in US dollars)

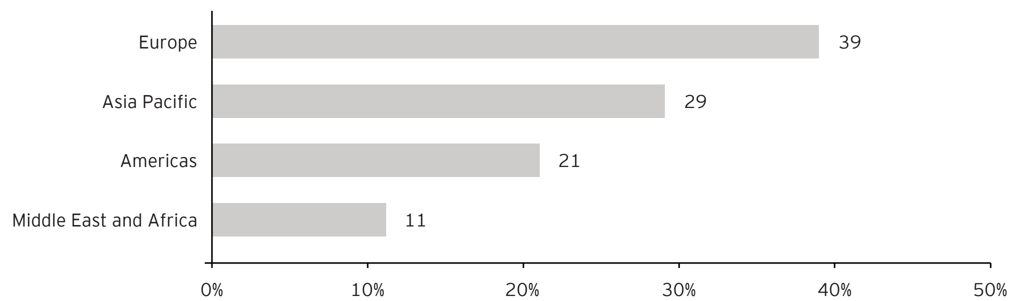


What is your primary industry?



1. Real Estate includes real estate, construction, hospitality and leisure.
2. Life Sciences includes biotechnology, healthcare and pharmaceuticals.
3. Transportation includes airlines, rail, truck, logistics and distribution.

In which region are you personally located?



Contacts

Area	Name	Phone	Email
Americas	Gerry Dixon	+1 212 773 7824	gerry.dixon@ey.com
Europe, Middle East, India, Africa	Martin Studer	+4 1 58 286 3015	martin.studer@ch.ey.com
Far East	Eric Chia	+86 21 2629 3737	eric.chia@hk.ey.com
Japan	Sanjay Narain	+81 33 503 2842	narain-snjy@shinnihon.or.jp
Oceania	Rob Perry	+61 3 9288 8639	rob.perry@au.ey.com

Ernst & Young

Assurance | Tax | Transactions | Advisory

About Ernst & Young
Ernst & Young is a global leader in assurance, tax, transaction and advisory services. Worldwide, our 135,000 people are united by our shared values and an unwavering commitment to quality. We make a difference by helping our people, our clients and our wider communities achieve their potential.

For more information, please visit www.ey.com

Ernst & Young refers to the global organization of member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients.

www.ey.com

© 2009 EYGM Limited.
All Rights Reserved.

EYG no. AU0349

Ernst & Young is committed to minimizing its impact on the environment. This document has been printed using recycled paper and vegetable-based ink.

This publication contains information in summary form and is therefore intended for general guidance only. It is not intended to be a substitute for detailed research or the exercise of professional judgment. Neither EYGM Limited nor any other member of the global Ernst & Young organization can accept any responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication. On any specific matter, reference should be made to the appropriate advisor.