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How Boards Can Institute A Risk-Centric Culture

Law360, New York (August 10, 2009) -- When times are tough, enterprise risk management (ERM) often becomes a popular topic of conversation among boards and executives. But, when times are good, risk is rarely discussed. Taking into account that crises often arise during times of great prosperity, why is that?

Consider recent examples of risk-based incidents that have reared their heads in the midst of euphoria.

Return-hungry investors appeared to ignore the "sub" prefix when investing in sub-prime mortgages prior to 2008, contributing to a precipitous drop in real estate prices. Their actions pushed the strongest housing market in decades off the cliff.

In 2000, the dot-com bubble burst, taking a fast-expanding technology industry with it.

Although hindsight is 20/20, many companies would have been better prepared to address these crises if they had instituted a risk-centric culture prior to economically challenging events and not after them.

Recent research supports these trends in risk management. According to a study published by Accenture, 85 percent of corporate executives say their risk management procedures require more than significant revisions — they need an overhaul.[1]

These results illustrate the discontent executives and directors share in the way risk management practices led to mismanagement of the current crisis.

We believe that the onus is primarily on directors to manage enterprise-level organizational risks. The best way for directors to manage risks is to instill a culture of risk management at all levels of an organization.

This culture can be fostered by setting an appropriate "tone at the top," creating an

organizational structure that emphasizes ERM and by developing and articulating a clear risk management policy.

The "Tone" at the Top

When professionals speak of an organization's "tone at the top," they are frequently talking about the tone set by high-level managers and CXOs (i.e. CEOs, CFOs and COOs). However, the tone at the top does not begin with these individuals, but rather, with the board of directors.

Directors represent the highest level of an organization. These individuals are ultimately most accountable to shareholders for organizational performance.

Shareholders cannot remove C-level executives. They can, however, remove directors they feel are not fulfilling their duties. As such, directors should take an active role in setting an ERM-focused tone at the top of organizations.

This tone begins with directors' active participation in shaping what is perhaps the most important of all ERM policies — an organization's culture.

An organization's culture is its first line of defense in ERM. When all employees are vigilant with respect to risks, the risks will be quickly rooted out and addressed.

While internal controls are effective at preventing, detecting and correcting risks, no amount of internal controls can act as a substitute for a strong, risk-focused culture.

Moreover, organizational culture is also one of the most cost-effective components of ERM. Culture costs little, but the value it reaps can pay dividends — literally.

Directors can foster an ERM-focused culture by meeting with C-suite executives and formulating concrete goals that emphasize not only rewards, but also risk management.

In today's world, many executives receive remuneration in the form of stock options or restricted stock. These types of compensation often reward executives for achieving high levels of performance (e.g. growing revenues, profitability, or market share).

However, in an ERM-focused culture, such remuneration should also reward executives for managing risks effectively — even when this may mean sacrificing short-term performance.

Some methods directors can use to reward executives for successfully mitigating risks

include merit pay that contains long vesting periods (encourages long-term earnings optimization) or pay that is tied to long-term volatility of earnings (encourages low volatility as opposed to short-term gains).

Alternatively, directors can elect to compensate executives with higher base salaries and lower amounts of incentive-based pay. This suggestion contradicts current trends in executive compensation, but it has been argued that current remuneration packages encouraged the behavior that led to the current economic crisis.

Reshaping compensation packages may encourage C-suite executives to make decisions that are best for the company in the long term.

Directors can also set an ERM-focused tone at the top by taking a critical look at estimates provided by executives. Some questions directors should ask are, how have historical management estimates of financial metrics compared with realized values? How do these estimates compare with those of competitors? And, do executives appear biased in their estimates?

If the organization has recently made acquisitions, directors can ask, how have estimates of potential target companies compared with their actual performance? If these estimates do not concur with realized financial performance, what is the cause of such discrepancies?

Asking these questions puts executives on notice that a board is not a passive entity. By itself, the perception of an active board will put pressure on executives to develop accurate, fact-based estimates that take into account potential risks the organization may face. Executives will then pass this message on to subordinates within the organization who are tasked with managing risks.

Organizational Structure

Many companies are already practicing risk management to some degree within their organizations. However, risk management policies and procedures are often disjointed within large, bureaucratic organizations.

Holistic, enterprise-level risk management is rarely practiced when responsibility for risk management is delegated to division-level managers. With some changes, these organizations can implement effective ERM policies that manage risks across the organization.

The creation of a Chief Risk Officer (CRO) position can help reinforce an organizational culture of enterprise-level risk management.

Despite the fact that many public and private corporations continue to suffer from the current economic crisis, few firms outside of the financial and insurance sectors have hired CROs.

In creating this position, the organization signals to employees that it values risk management and believes risk management is a permanent issue to be tackled.

CROs often report to a member of the C-suite, but we believe that they should report directly to the board. This will help ensure independence of the CRO's opinion, and also provides directors with a risk-focused check to the CEO's strategic and operational plans.

Boards may also find it beneficial to create a board-level risk committee to oversee and manage risks. This committee could evaluate risks associated with the organization's internal and external environments.

Risks within the internal environment might include employee turnover, quality control defects, production issues or sales-related problems. External environment risks might include supply chain shocks, industry-related risks or investor sentiment.

Currently, many boards delegate responsibility for risk management to audit, finance or other ad hoc committees. However, these committees are already tasked with myriad responsibilities.

Adding responsibilities for oversight of internal and external risks may create too great of a workload. As a result, these committees may not devote the proper amount of attention to risk management. Also, board-level risk committees can also help the organization better formulate risk management policies.

Developing and Articulating a Risk Management Policy

When developing a risk management policy, directors should first formulate a risk profile for the organization. Is the organization one that is risk tolerant or risk averse? How do investors feel about the organization's policy regarding risky projects?

This latter question is especially important for directors of publicly traded firms that have a significant portion of their outstanding shares held by institutional investors.

Institutional investors are finicky partners. If they perceive an organization is moving in a

direction that diverges from their portfolio goals, they may sell off shares en masse.

Directors can formulate a risk profile by examining the organization's past successes and failures, and those of its competitors. They can then contrast their organization's risk-reward profile with other market players and examine if it has been beneficial or detrimental to the organization.

Once a risk profile has been established, it should be shared with employees in a top-down manner. Directors and executives must also ensure that the profile is considered when strategic decisions are made.

If these decisions are incongruent with previously established beliefs, employees will not have a clear understanding of the organization's risk tolerance. Directors should adhere to a steadfast policy of removing executives who make decisions that are inconsistent with an organization's stated risk management policy.

A risk management policy must also include contingency plans for actions to take during risk-based events. Aside from natural disasters, such events might include precipitous stock-market declines (e.g. Oct. 19, 1987) or unfavorable litigation outcomes.

Directors should participate in the formulation of contingency plans because they will often be active participants during events. Plans should outline strict procedures for calling emergency board meetings and identifying key individuals responsible for managing various types of risks.

For example, plans could state that once an incident occurs, the board should meet via phone twice weekly until a majority of the board feels that the incident has been properly mitigated. In addition, plans should be fluid so that they can be tailored to different crises.

Conclusion

Regardless of organizational performance, risk management and risk-based decision-making should hold a key role in organizations. This is the responsibility of the board of directors. Within this article we have specified ways in which directors can foster a culture of ERM within organizations.

By creating a "tone at the top," implementing a risk-focused organizational structure and developing an enterprise-level risk management strategy, directors can ensure that the organization is prepared for risks it may face in the future, while also helping the organization

navigate through the current crisis.

--By Harry Cendrowski (pictured) and Adam Wadecki, Cendrowski Corporate Advisors

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[1] "Heeding Lessons from Economic Downturn, Majority of Corporate Executives Report Need to Overhaul their Approach to Risk-Management, Accenture Study Finds." July 6, 2009. newsroom.accenture.com/article_display.cfm?article_id=4848

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