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Foreword

New codes of practice and increasing pressure from investors have changed the roles and expectations of independent board members concerning risk. New regulation – in many cases imposing detailed public disclosure with criminal penalties for directors who sign off on false or misleading information – is focusing the attention of the board on monitoring and managing risk as never before.

Risk, however, is a broad term with many aspects, and boards have reacted in different ways to ensure it is adequately addressed. All board members are expected to do their homework and get sufficiently close to the business to understand its risks in some detail, while maintaining the distance necessary to be effective in their strategic and monitoring role. They have a key role to play as challengers and assessors of how executives are performing in managing risk – their remit is to balance performance and compliance. By asking the right questions and bringing to bear their experience and skills, they can help companies identify risks, understand their potential business impact and manage them effectively.

Many boards, however, have created dedicated sub-groups to address different aspects of the risk challenge – including audit committees, compensation committees and the growing number of risk committees. The roles of these groups differ from that of the overall board, and their legal authority may not be the same. The question is, do board members act differently in these distinct roles and is corporate governance being enhanced as a result?

Contributing to the current debate and dialogue around risk, Ernst & Young is conducting a series of research surveys in which we explore attitudes to risk and risk management, comparing viewpoints across key stakeholder groups including investors, senior executives, audit committees and other independent board members.

This is the third report in our series, presenting the views of nearly 150 independent, non-executive board members from 16 countries. We explored their overall views on risk and risk management, and asked them for their assessment of risk management challenges for companies where they held a non-executive appointment. The opinions and ideas they have expressed provide an enlightening picture of how audit committees and other non-executives differ in their approach to risk management.

We would like to acknowledge and thank all respondents for their time and their insights.

This report is the third installment in a major series of surveys Ernst & Young is running on the subject of risk. If you would like to contribute to this debate, please visit our dedicated risk website at www.ey.com/risk/letstalk



Thomas McGrath

Global Managing Partner, Client Service and Accounts

Executive summary

Note on terminology

We recognize that board structures and responsibilities are not uniform around the world and differ to meet requirements across regulatory regimes. In our survey, we spoke only to independent board members – those in a non-executive capacity – rather than to those who hold an executive role within the organization. We have sought to explore the views of these individuals as a collective, without explicit reference to the status of their particular board.

We therefore use the term 'board members' to stand for independent non-executives only. We use the term 'executive management/managers' to describe corporate leaders, who may or may not be members of the board. Again, this term is meant to stand for a specific group of people, and is not used as a technical term.

Throughout our report, in both the charted figures and the text itself, we have abbreviated the term 'audit committee members' to 'ACMs' and 'other independent or non-executive board members' to 'non-ACMs'.

As businesses grow large and complex, decisions are delegated to separate individuals, groups, and committees. There is an increasing challenge for management to understand and control what the right and left hand are doing and for the board to oversee it. In complex structures with many subsidiaries – where the management organization is separated from the legal and financial organization – risk management can become disjointed and disconnected.

Risk doesn't recognize organizational charts. It doesn't confine itself to functions and units, processes and roles, but travels through the enterprise in an interdependent and connected way. It is therefore not safe to practice risk management on an exposure-by-exposure basis: risks must be recognized and managed holistically across the entire organization.

For this reason, it is well accepted that companies need a comprehensive process and structure to identify and manage risks. Creating this process – the risk management framework – is not an exercise in bureaucracy but a way to manage a company's risk prudently and effectively and at the same time allow management the confidence to make decisions to achieve growth. And it is the independent, non-executive board members in their oversight capacity who bear the ultimate responsibility for this.

Based on a deep understanding of the business and its environment, they need to decide how much risk organizations should reasonably take on as they move forward.

Much recent discussion on risk has centred on the audit committee, with its focus on compliance and financial reporting risk. By compliance, we mean the interpretation and application of regulation and applicable laws, including exchange listing requirements. Given the interdependent and connected nature of risk, we have structured our research around both audit committee members and other independent members of the board. We wanted to explore the views of both these groups – and any variances between them – to establish whether companies were getting the holistic perspective on risk that they require. If the board is going to operate increasingly through sub-groups, who will form the holistic view?

We know from our experience that the audit committee's role in compliance and financial reporting has resulted in a deep knowledge of risk management frameworks. They have properly focused on the task at hand, ensuring that the fundamentals are in place to support the creation of value. Our question was how the skills and competencies they have developed in fulfilling this role can be leveraged to address forward-looking growth issues. How can they work effectively as part of the wider independent board, whose focus extends to performance issues?

We believe that using the particular strengths of the audit committee to serve the performance objectives of the board as a whole will gain benefits for the business far beyond corporate governance requirements. It will arm the business fully with a framework of ownership, communications and a formalized process aligning risks and corporate objectives. It will strengthen their ability to respond to risks as yet unknown.

Independent board members told us that:

- **The risk landscape is changing.** Two-thirds of our respondents believe that risk levels have risen over the last two years. Their views reflect those of the corporate leaders we interviewed in *Companies on risk*, our previous global survey.
- **Board members focus on different aspects of risk.** Audit committee members (ACMs) identify rising levels of regulatory and compliance risk; non-ACMs perceive greater levels of business and competitive risk.
- **Compliance with standards and regulations and avoiding major threats** is the board's priority; ACMs and non-ACMs alike are focused on reducing the downside of risk. This emphasis on risk mitigation raises potential tensions between board members and company senior management, whose growth and performance objectives mandate active risk-taking.

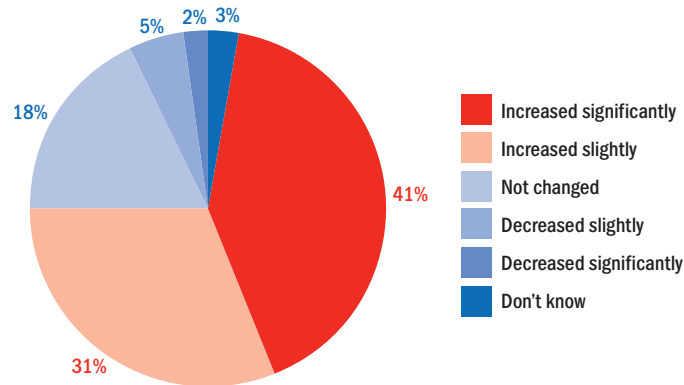
- **Board members**, particularly in the Americas, generally believe that risk is well managed, and **are confident in the information on risk they receive** from internal teams and executive managers. There is some regional variation: 82% of Americas respondents are very confident in the information they receive, compared with 57% in Asia and 32% in Europe. Respondents in Asia and Europe, without a consistent internal control reporting framework, are more likely to say that they are 'fairly' rather than 'very' confident.
- However, just over **a third of board members believe some types of risk are not well managed** by their companies, and one-third of board members have also pushed for change in the senior management team of a company on the basis of poor performance on risk management. Those who feel there are gaps point to performance risks as not being sufficiently well managed.
- The biggest contribution boards believe they have made is through **establishing a formal process and providing an independent and objective perspective**. Extending such frameworks beyond compliance suggests the potential to add value through better collaboration and skills transfer, both between ACMs and non-ACMs, and between independent directors and executives.
- **Priorities and challenges for the future** include dealing with regulatory risk, identifying emerging risks, and improving systems for risk management.

ACMs vs non-ACMs?

Our experience tells us that ACMs think of themselves as board members first and ACMs second; in fact, they usually sit on more than one board and may not be ACMs on the other boards on which they sit. We are aware that these are not discrete groups. However, the findings from our survey suggest that when considering risk and risk management issues in particular organizations, the views of ACMs and non-ACMs are influenced to a degree by their specific roles. We see that particular circumstances do have some effect on attitudes and, possibly, behaviors. We have explored these differences in viewpoint, where appropriate, in order to contribute to the discussion of how boards and companies can be more effective on risk management.

Our findings

Figure 1 Board members report increasing risk levels



Q: Has the overall level of risk faced by companies changed in the last 2-3 years?
Percentage of all respondents (148)

“Globalization means increased risk, especially if one has got business abroad, currency risk, energy risk, political risk and sabotage risk.”

– non-ACM, Sweden

“The world is getting smaller... there is the globalization of companies and companies are operating in more than one country.”

– non-ACM, Singapore

The risk landscape has changed

All board members – whether ACM or non-ACM – share a view that risk levels have increased. 72% of board members believe that the overall level of risk that they face has increased in the past 2-3 years – indeed 41% of our respondents believe that the overall level of risk they face has increased significantly. What has happened in the past 2-3 years to drive this perception? Globalization has been a long-term phenomenon. The stock market crash happened at the end of the 1990s. The Sarbanes-Oxley Act was passed in 2002.

There was some variation in perception by region: respondents in Asia were more likely to say that risk has increased significantly, at 68%. The most dynamic region in the world today, Asia reflects most clearly global changes and developments. Respondents in emerging market countries as a group also perceive higher risk levels: 55% report a significant increase compared with 37% in developed market countries.

However, on a global basis, the pattern of response was consistent. Board members believe the risk landscape has changed for the worse, and a sizeable number believe risk has increased significantly.

Figure 2 The board as a whole identifies regulation and compliance as the primary area in which risk has increased



Q: In what ways has the risk increased?
 Percentage of respondents saying risk has increased (109)
 This chart represents spontaneous responses to an unprompted question.

We asked the respondents who said that overall levels of risk have increased to tell us in their own words what in particular was driving this change. They cited specific types of risk, the implications of increasing risk levels, and the effect risk had on them as individual board members.

By far the major cause of increased risk, however, was seen to be regulatory risk and associated compliance concerns. This was followed, some way behind, by business environment risk. Those people who have argued that recent legislation has increased the

board’s focus on how they are operating, rather than simply on what the organization is doing, seem to be supported by this finding. Interestingly, the increased audit scrutiny that flows from some of the new regulation was perceived to be a much lower risk than the legislation itself.

As noted in our Executive Summary on p3, while we are clearly not claiming that ACMs and non-ACMs are in fact two separate groups, we do see that their attitudes and perceptions are shaped on certain issues by the fulfilment of their roles.

The structure and legal responsibilities of the board vary around the globe and a growing number of boards are either choosing – or are forced to have – sub-committees focused on specialist areas such as audit, risk, or compensation. Sarbanes-Oxley and the 8th Directive, for example, explicitly require the audit committee to oversee risk management. Our findings suggest that in doing this, these committees focus primarily on compliance and financial reporting risks rather than a broader definition of risk management. In addition, we see this focus on compliance as, very simply, a manifestation of their priorities in fulfilling their role.

For ACMs, unlike non-ACMs, board accountability has not increased – it has always been a ‘given’. Non-ACMs are now explicitly recognizing the accountability that has always been there for the audit committee.

“Risk has increased as a result of the range of new regulations coming into effect.”

– ACM, Australia

“In terms of governance there has been a huge increase in awareness of risk that companies are now exposed to.”

– ACM, India

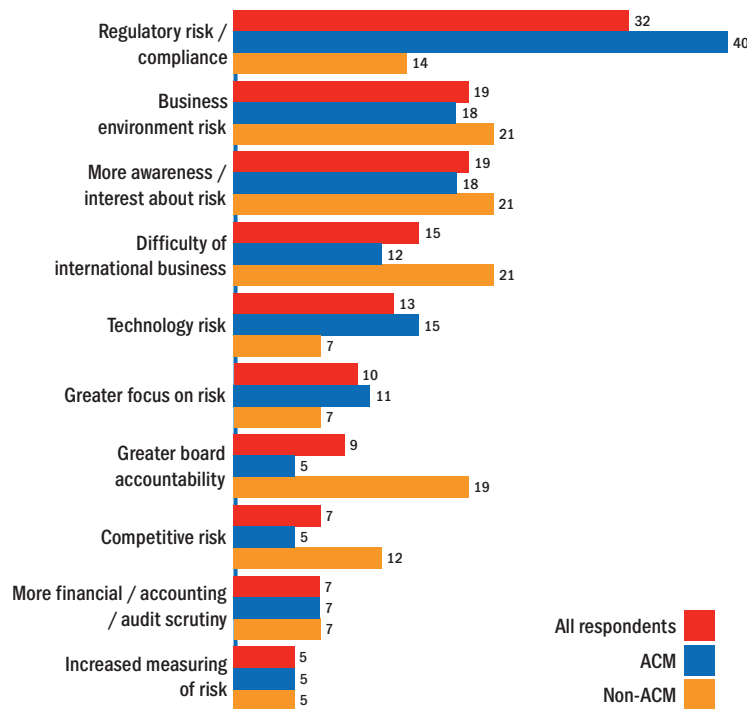
“You are much more aware of lawsuits. People seek legal counsel now more quickly than in the past.”

– non-ACM, Canada

“Due to globalization there is exposure to outside factors which are beyond one’s control.”

– non-ACM, Hong Kong

Figure 3 Board members have different perceptions on how risk levels have increased



Q: In what ways has the risk increased?
 Percentage of respondents saying risk has increased (109), ACM (78), non-ACM (31)
 This chart represents spontaneous responses to an unprompted question.

Non-ACMs place significantly more emphasis on business and performance risks than on compliance risk. Also reflecting their role, they are significantly more likely than ACMs to mention market risks, the difficulty of international business, or competitive risk.

This difference in responsibilities and perspective suggests that there is a balance that companies need to strike between the need (from internal and external stakeholders) to meet both compliance and performance objectives. As we will propose throughout this report, our view is that this very difference in focus is a fundamental strength of the board as a whole – one that can be leveraged to enhance the organization’s ability to manage risk in an holistic way.

This result suggests to us that discussions on risk that take place in the audit and risk committees should be continued by the whole board. Having ensured that the risk management process is functioning and effective, the whole board can leverage this in operational and strategic decision-making.

Key factors for successful risk management

Our experience suggests that best practice risk management must be tailored to the individual company, but will include clarity on ownership, effective communication, a process for both identifying risk and aligning appropriate risk management, the active involvement of the board and a clear program of stakeholder communications.

We asked board members to evaluate the relative importance of key measures. ACMs and non-ACMs were consistent in their responses to this question: while they differ in terms of relative emphasis on various areas of risk, overall they are agreed on the best approach.

Figure 4 Key factors for successful risk management



Q: How important are the following aspects to the success of a company's approach to risk management?
 (High rating: % giving 8, 9 or 10 on a 1-10 scale) Percentage of all respondents (148)

The most notable finding is what they didn't say. Respondents assign the lowest importance to the one external program in this list – a policy for communicating to external stakeholders. In our experience, this is a critical and growing area for companies to address, with the board of directors and executive management working together to communicate with external stakeholders. We discuss external communication, and its implications for risk management frameworks and internal reporting, on page 17 of this report.

Nor is active board involvement, while considered to be important, the top priority. This finding is encouraging, suggesting an appropriate recognition and assessment of the role of the board in general, and on risk management in particular. They are not trying to repeat the work of the executive committee, or trying to micro-manage. The board should have realistic involvement at the right level, and not exert too much influence on the day-to-day running of the organization.

“There needs to be a clear setting of the risk tolerance, clear guidelines for managing risk, and systematic risk management rather than in an ad hoc way.”

– ACM, Australia

The primary responsibility for risk management should be pushed as closely as possible to the people nearest to the risk.

Board members believe that clear ownership of risk in the company is the most important factor in successful risk management: 87% rate it as a very high priority. However, that does not tell us where the ownership should rest. We asked respondents to tell us who (or what group) ‘owns’ risk within the company. ACMs and non-ACMs were largely in agreement in their response – they are most likely to identify themselves first (40%), followed at some distance by the CEO (22%). When we asked the same question in our earlier *Companies on risk* survey, corporate respondents reversed this pattern, putting themselves first (30%) and the board second (20%).

One explanation for the difference in findings is that respondents are applying different meanings to the term ‘ownership’ – the board focusing on authority and the senior management focusing on accountability. We are clear, however, that while the ultimate responsibility for ensuring the effectiveness of risk management rests with the board, it is the executive managers – those driving the organization – who need to take ownership of risk. The primary responsibility for risk management should be pushed as closely as possible to the people nearest to the risk. Effective risk management is an ongoing process rather than an episodic report.

We would advocate an active discussion of risk ownership between management and the board, to provide clear and pragmatic direction on the ownership of specific risks to ensure they are handled efficiently.

These findings provide a strong indication of the board’s desire to raise their level of ownership and/or involvement, confirming the increased recognition of the importance of risk management. Risk management, however, is management; the objective is to make better decisions. All levels of the organization have a role to play, and are in turn affected by other groups. Total risk coverage is achieved only if a company is able to coordinate its risk management functions and activities in a realistic and pragmatic way.

Our view is that for board members to contribute to the discussion in an effective way, they need a framework to address all risks, including and extending significantly beyond compliance.

Our survey respondents support this view. When we asked them to identify key factors for successful risk management in their own words, 28% (the highest number) said that a framework for managing risk was critical. This ‘framework’ captures the aspects to which they gave the highest importance – ownership, communications, and a formalized process aligning risks and corporate objectives.

The role of the board on risk

Board members considered three ways of characterizing their role on risk: (i) setting the strategy for risk management, (ii) providing guidelines for the board and senior management to work together, and (iii) reviewing and responding to information from executive managers. We asked them to select one option that best described their role.

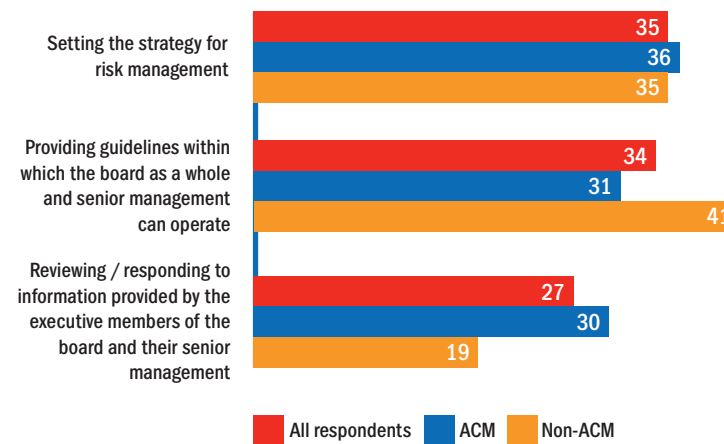
Overall, our respondents are equally divided between setting the risk management strategy and moving beyond this to provide guidelines on how the strategy should be implemented. This continues the trend we noted earlier, of boards seeking to become more actively involved.

However, when we segmented the board members by their ACM or non-ACM status, there was a clear distinction in how they saw their roles. While responses between the two groups are virtually the same in terms of setting the strategy, non-ACMs are significantly more likely to characterize themselves as providing guidelines on implementation, leaving execution to executive management. ACMs are significantly more likely to see themselves as more involved in the detail, and taking an active role – and again this reflects the nature and requirements of their role.

We see boards trying to find the right balance between providing oversight and allowing enough leeway to achieve performance goals. 83% of board members tell us that their role has changed in relation to risk over the last 2-3 years. They say this change is largely around greater accountability, a bigger role, and increased time investment. Arguably, the board has always had this accountability, but increased discussion of risk is enhancing their awareness and we are seeing the board take steps to improve their exercise of this function. The reality of a changing risk landscape has called for more effort and attention from board members.

83% of board member respondents say their role has changed in relation to risk over the last 2-3 years.

Figure 5 The role of board members in relation to risk

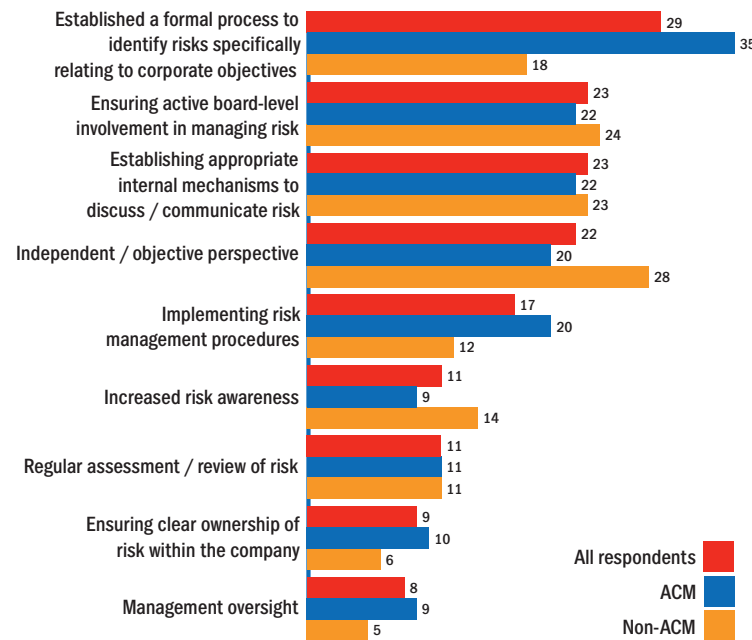


Q: Which of the following statements best describes the role of the independent members of the board as it relates to risk?

Percentage of all respondents (148), ACM (104), non-ACM (44)

So how are boards responding to the changing risk landscape?
We asked board members to describe the most significant contribution made by the board in relation to risk.

Figure 6 Independent board members have helped establish a process to identify risks to corporate objectives



Q: Which is the biggest contribution to the company that the independent members of the board have made in relation to risk?
Percentage of all respondents (148), ACM (104), non-ACM (44)
This chart represents spontaneous responses to an unprompted question.

The overall conclusion we draw from these comments is that on the whole, board members are fairly consistent in their view of their contribution in relation to risk. This is another positive finding, one that points to good communication and alignment within the board. As a whole, board members believe that the biggest contribution they have made in relation to risk has been to establish a formal process, to ensure effective internal discussion, to get actively involved and to provide an independent and objective perspective.

Interestingly, the provision of an independent and objective perspective – arguably the central role of an independent board member – no longer tops their perceived contribution and has been overtaken by active process enhancement. Equally – given the board’s belief in clear ownership of risk as being central to effective risk management – both ownership and regular assessment and review fall towards the bottom of their perceived contribution.

Two key differences, however, do emerge. We see ACMs focusing understandably more on the process – on formalizing the risk management approach. A third of the ACMs interviewed point to establishing a formalized process to identify risks as their most significant contribution. Non-ACMs, on the other hand, emphasize the independent perspective that they bring. This response adds another dimension to the distinction in focus on compliance and performance risks. We can characterize the ACM approach to risk management as more formal and process-oriented, and the non-ACM approach as more informal, intuitive and event-driven.

The board's risk management priorities

Board members see themselves as more accountable, more active and involved in a company's approach to risk than in the past. To better understand their priorities we asked them to rate the level of emphasis the company should place on a number of business objectives. In what ways do they intend to influence the focus of risk management activities within the company?

The responses in Figure 7 show ACMs and non-ACMs consistent in their view of compliance and risk reduction as first principles. Unless the fundamentals are right, there will be no opportunity to add or create value.

Across all risk types (compliance through to performance) boards tend to use risk management to manage the downside. They tend to drive risk management competencies so that management decisions are based on a structured evaluation of what might go wrong.

Figure 7 Board member focus is on downside reduction



Q: What level of emphasis should the company's approach to risk management place on the following?
 (High rating: % giving 8, 9 or 10 on a 1-10 scale) Percentage of all respondents (148)

We would argue that this is reflective of the board's primary role to protect shareholder interest. It could also be argued that this emphasis is a beneficial anchor in the decision-making process of the board. The upside of business decision-making is already adequately covered in strategic processes like strategic planning and operational leadership. These might be enhanced and made more rigorous by emphasis on downside possibilities but do not need to be subsumed into a risk-management mentality.

Managing compliance is the necessary condition that allows a company to make decisions for growth. However, this focus on risk mitigation poses an interesting dynamic – and almost certain tension – between board members and company senior management, whose growth and performance objectives mandate active risk-taking. The challenge, of course, is to make this a creative tension. While we will see that overall, board members believe that risk is being managed successfully across organizations, a number of comments made by board members highlight this tension, pointing to the need to keep executive managers focused on risk:

"The board focuses management attention on the importance of having risk considered throughout the organization." – ACM, UK

"Our role is to get the whole organization to focus on risk, from the CEO down." – ACM, Australia

"The role of independent board members is to watch over the collective interest, to watch over the governance rules and to ensure the transparency of all management actions." – non-ACM, Brazil

"We ask a lot of hard questions and make sure that everyone is acting in a transparent way." – ACM, US

"We need to find a balance between business risk and development of the company in order to tolerate risk on a sensible level and for it to serve the company's development."

– non-ACM, Poland

The board's challenge for executive management

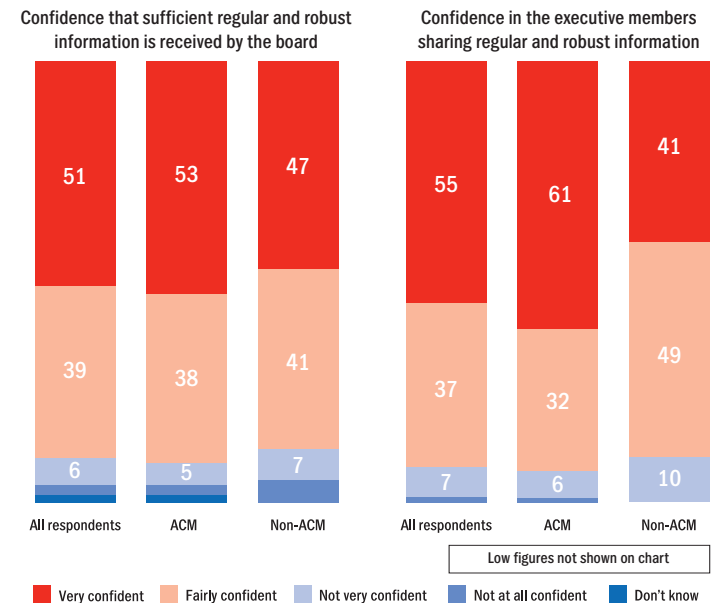
Responses clearly show that board members believe that risk is being relatively well managed. On a scale of 1-10, respondents give their organization a mean score of 7.5.

The findings in Figure 8 show trust in both the people and the processes. We asked board members how confident they were that executive board members – such as CEO and CFO – received good information on risk from their internal teams, and also whether executive board members then shared this information with their independent colleagues. The majority, both ACMs and non-ACMs, show a high level of confidence that they are getting the information they need. Arguably, low scores in response to these questions would have been far more disconcerting.

Clearly, board members need to confirm that their positive perception is grounded in the true situation. Their very independence and part-time attendance means that they may have a less clear view than executives – certainly a delayed and less-detailed view. In order to fulfil their oversight role, they rely on information from the executives. Our view is that in order to ensure the best information possible, they should increase their efforts to tap other sources and not be solely dependent on executives.

ACMs are a little more likely than non-ACMs to have a high level of confidence in the information from executives. Because of the nature of the role, ACMs are closer to the details; their confidence may well be based on their experience and familiarity with the judgment of management.

Figure 8 Do board members have confidence in information on risk?

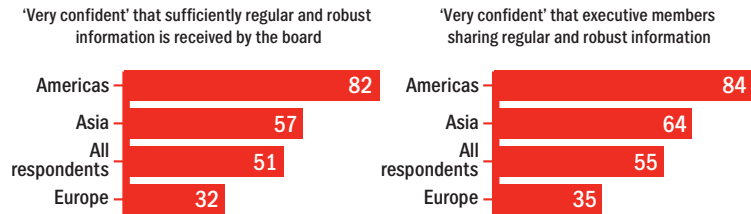


Q: How confident are you that the executive members of the board receive sufficiently regular and robust information on risk from their internal teams?

Q: How confident are you that the executive members of the board share sufficiently regular and robust information on risk with independent board members?

Percentage of all respondents (148), ACM (104), non-ACM (44)

Figure 9 Americas board members report higher confidence in risk information



Q: How confident are you that the executive members of the board receive sufficiently regular and robust information on risk from their internal teams?

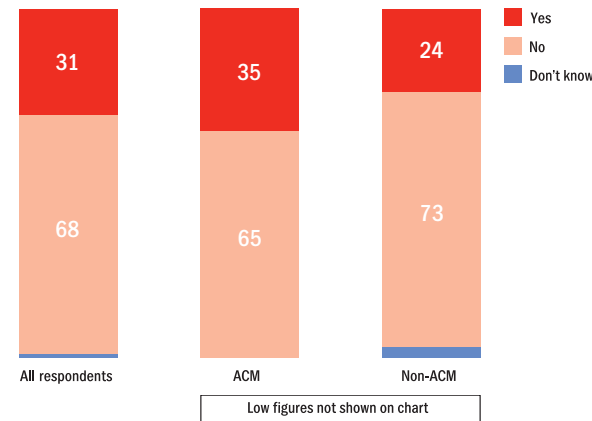
Q: How confident are you that the executive members of the board share sufficiently regular and robust information on risk with independent board members?

Percentage of all respondents (148), Americas (47), Europe (69), Asia (32)

Comparing regional reactions to these questions, in Figure 9 we see a significantly higher level of confidence in Americas respondents than in other regions. 82% are very confident that regular and robust information is received by the board, compared with 51% overall and only 32% in Europe. This may be explained by the high level of focus on corporate governance in the US over the past 3-4 years. In the absence of a consistent European internal control reporting and regulatory framework, board members there are led to describe themselves as 'fairly' rather than 'very' confident.

However, sometimes bad news – and almost always very bad news – does travel upwards and spurs board members to act. In fact, one-third of the board members in our survey have taken action by pushing for change. Given that only cases of real or perceived failure

Figure 10 Have board members pushed for changes in executive management due to poor performance on risk management?



Q: Have there been instances where you have pushed for changes in the senior management team in a company because of its failure to identify or manage risk effectively?

Percentage of all respondents (148), ACM (104), non-ACM (44)

have triggered their action, this finding shows a high degree of willingness to intervene in the senior management team of a company on the basis of poor performance on risk management.

The challenge is for executive management not only to ensure that the approach to risk management is robust, but to maintain an open dialogue with the board on the challenges faced in this task. Our sense is that in addition to being risk-averse, board members are equally surprise-averse.

Risk areas to be addressed

While they are largely content with the way risk is being managed, and have trust in people and processes, the board members we spoke to are far from complacent about this issue. Over a third of the board members believe that some types of risk are not being sufficiently well managed by their companies. The comfort of ACMs who are more exposed to the detail is actually a little lower than non-ACMs. This is potentially strong self-criticism, which adds another dimension to their overall 7.5 rating – suggesting room for improvement. It will be a challenge to manage external communication with stakeholders, whose natural response would be to ask for the gaps to be addressed immediately. Board members currently would be tempted to opt for a disclaimer, since they depend on executives for risk management information.

When asked to identify what risks are not being sufficiently managed, board members focus on business environment risk as being the most exposed. This is, of course, the area in which they claim to have least involvement and influence. Interestingly, competitive risk – which earlier they reported as not being a major source of increased risk – is perceived as one of the major areas where they consider risk is not being sufficiently managed. Equally surprising is the relatively low level of concern about reputation risk. There is a growing body of evidence suggesting that reputational risk is a high concern of the investment community.

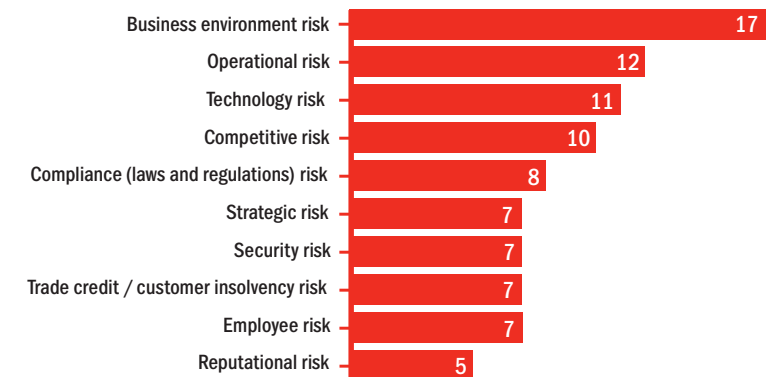
Board members don't believe that the answer lies in spending more. 85% say that the organization has sufficient resources invested in risk management. Risk needs to be better managed, but without increasing investment levels.

So how can this exposure be reduced? If we accept that board members may not be close enough to the business to know the full extent of the risk profile, and are not actively involved in day-to-day risk management (nor should they be), then what is the way forward to reduce these numbers?

In *Companies on risk*, our findings from corporate leaders highlighted alignment across business units and the risk management function as key to a more effective use of the existing investment in risk management. Our research with board members takes us a step further, and offers the insight that the skills and experience of the board could be put to better use to enhance a company's approach to risk.

35% of board members believe that some types of risk are not being sufficiently well managed by their companies.

Figure 11 Risk areas where board members want management to reduce risk



Q: What types of risk do you feel are not being sufficiently well managed?
Percentage of respondents saying that risks are not being sufficiently well managed (51)
This chart represents spontaneous responses to an unprompted question.

Can the board be more effective on risk?

A number of questions throughout our survey sought to explore the perspective that different members of the board have on risk. The findings allow us to characterize these groups more broadly.

ACMs have a compliance focus, and more experience and comfort with formal elements of risk management. A high proportion come from a financial background, as required for some of them in a number of jurisdictions. The role of non-ACMs requires that they take a broader perspective. Their focus on performance risk reflects their business orientation: they are used to dealing with risks that are not formally managed, and may instead rely on a more intuitive approach.

Both groups are looking to reduce the downside of risk, whatever the risk type. But given that the risk profile is always changing, the challenge for an organization is to get the right processes, tools, people and framework to deal with this evolving profile.

So how can the talents of non-executives as they fulfil their roles be combined to address the full range of risks in a comprehensive way?

Our view is that companies have the opportunity for leveraging the experience and efforts of their independent board members to take their contribution in terms of risk management even further. The starting points for this are to keep risk as an agenda item for the whole board and improve discussion both within the board, and between the board and executive management.

Put in the broadest way, the full board can benefit from a more formalized process being applied to risk management. Ways to achieve this might include:

- leading risk discussions through ACMs, to benefit from their knowledge of risk management tools and methodology
- applying compliance risk management frameworks to performance-related risk areas
- using non-ACMs as challengers on performance risks that are not easy to manage.

Companies have the opportunity for cross-fertilizing the skills and experience of their independent board members, to take their contribution in terms of risk management further.

Clearly, this effort needs to go beyond independent board members. To define new risks and enhance risk management, discussion between the board and company management needs to be intensified in a common language. Executive management can also benefit from the differences in attitudes and skills of their independent board members. In particular, senior management has the opportunity to make better use of interaction with board members to address performance-related risks.

Actions for executive managers include:

- leverage the experience and skill set of non-ACMs in approach to performance risks. These are difficult to assess, and even more difficult to manage
- eliminate the perception gaps on risk exposures. Board members are clearly willing to push for a change in senior management if they think that things are going wrong. Ensuring that there are no misunderstandings and getting earlier involvement is essential for the board to make the best judgment about management performance
- consider better use of existing procedures, methods and tools (the framework) developed on compliance risk management for performance risk management.

Throughout the survey, we have seen that the roles of board members, in particular ACMs, lead them to look at things from a different perspective. Without being categorical, we can say that the roles board members play allow us to characterize their views on a number of aspects.

How are board member attitudes affected by their role on risk?



Open and transparent communication on risk

During our research over the past year, we asked investors, senior management and board members a core set of consistent questions. One question was, how can the company best demonstrate to major investors that it has a focused and reliable approach to risk management? We are interested in exploring the relationship between risk management and the creation of shareholder value, and this seems a sensible starting point for discussion.

The board members' response is consistent with the two other groups surveyed to date. Open communication (and transparency) are seen as absolutely essential to demonstrating risk management. We also

Figure 12 Boards see open communication as the key to demonstrating good risk management



Q: How can the company best demonstrate to major investors that it has a focused and reliable approach to risk management?

Percentage of all respondents (148)

saw that while investors would prefer a one-to-one dialogue, board members (and company management) are not always prepared to engage in such a manner, opting (as below) for a section in the annual report.

Interestingly, we see regulatory compliance scoring poorly on this question, suggesting that board members recognize that compliance is treated as a 'given' by investors.

We see the issue of open communication and transparency as a cardinal issue in a company's risk management approach: to be able to fulfil this hinges on key elements of the risk management framework.

Requirement for external communication on risk needs	Implications for internal risk framework
Aligned messages across speakers representing the company	Consistent risk information across all levels and business units
Consistency with other corporate messages	Risk management needs to be aligned with strategic objectives of the organization
Holistic, presenting an overall view of relevant risks and the risk management approach	Risk information not siloed within risk functions or business units
Tailored to specific stakeholders, including regulators, investors, rating agencies, wider community	Risk assessment takes into account the impact of company risks on range of stakeholders

Frameworks for the future

The findings of our survey – both the statistical data and the comments our respondents made – together with our experience of working with clients on risk issues, suggest to us that in the short term, companies have compliance risk well covered. Overall, compliance has been prioritized, addressed, and the skills and processes are in place.

The challenge now is to use these skills and processes in order to help achieve performance goals. The ultimate test of value is whether a company would continue to follow a course of action, even if there were no regulatory requirement to do so.

The findings, however, suggest to us that there are gaps in how companies are dealing with performance-related risks. This is an area of concern, particularly for the non-ACMs. We have observed

that the risk discussion needs to move beyond compliance, to address the downside of performance risks. Our view is that companies have the opportunity to use non-ACMs in a more focused way, and also leverage the investment in compliance risk management to deal with these other types of risk.

Another key theme has emerged: the increasing need to be more forward-looking, and to resist the urge to focus on the short term or the past. After regulatory risk, those respondents who describe challenges in their own words highlight identifying and managing emerging risks as key challenges over the next 3-5 years.

The need to ‘know what you don’t know’ is also a consistent thread in respondents’ comments.

Figure 13 Key future risk challenges



Q: What do you see as the key risk management challenge for the company in the next 3-5 years?
Percentage of all respondents (148) This chart represents spontaneous responses to an open-ended question.

“The biggest challenge going forward is to get insight into the risks which are unknown at the moment. New processes will help us gain knowledge into how to minimize risk.” – ACM, Netherlands

“The main challenge is proactively identifying and managing risks as they emerge.” – ACM, Australia

“We work in a changing environment. There are constant developments in the market which necessitate understanding of new risks and new issues in risk management.” – ACM, France

“The key challenges and new risks come from globalization. The business environment is increasingly affected not only by what is happening inside the country, but what is outside also.” – ACM, India

“Market circumstances are changing rapidly. Companies have little time to adjust to these conditions and the risk management implications that come with them.” – non-ACM, Italy

“We are not worried about internal issues. Our main concern is regarding external situations that we don’t know about yet, and cannot control.” – ACM, Sweden

“Our challenge is that risk management develops into a real input factor for the strategic development of the company. That requires a consistent procedure that is conducted regularly and allows us to notice developments in time.” – ACM, Switzerland

“The biggest challenge is the fast-moving external environment.” – ACM, US

Our conclusions

Our work to date suggests two overall conclusions. The first is that in order to succeed, companies need to be highly effective in dealing with both compliance and performance risks. Addressing compliance risk is the license to operate – until an organization has successfully managed this, there is no point in addressing performance risks. Ensuring that compliance risks are managed effectively on a global basis is an ongoing challenge for organizations in the absence of shared regulatory standards worldwide. Having said that, we see that performance risks lie at the heart of value creation – which markets, which products, what price – and the entire logistical challenge of delivering the agreed strategy in a profitable way. In addition to the desire to manage the business for growth, companies are also looking at new requirements, such as the 8th Directive in Europe, that take a

broader perspective, stipulating reporting on operational and strategic risks in addition to compliance and financial reporting.

The shareholder expects appropriate risk management to be applied to both areas, and the board has a central role to play in both. If compliance risk is being addressed today in a more effective fashion, the key challenge going forward will be to identify and address unknown risks, particularly market performance risks.

However, there are no external standards for addressing performance risks. Our second overall conclusion is that companies need to take their own steps to address these risks in a more formalized way. They need to achieve an holistic, rounded perspective. To do that suggests the need to create a framework that enables the board to play an appropriate role in assessing performance risk. That role, however, is not to duplicate or second guess the executive management who have day-to-day responsibility and are best placed to lead on this, but to use their judgment and experience to challenge assumptions and expectations.

Taken together, these conclusions suggest to us that companies, boards and executive management alike have the opportunity now to take the skills, tools and methodologies in which they have invested to address compliance risk, and apply these to other parts of the business in a more forward-looking way.

Using compliance frameworks to create value



Survey approach

In February through April 2006 our researchers¹ interviewed audit committee members and other non-executive board members in large organizations across major industry sectors.

Revenue	Respondents
\$5 billion plus	13
\$2 billion – \$5 billion	12
\$1 billion – \$2 billion	40
\$500 million – \$999 million	19
Below \$500 million	49
Revenue not known	15
Total	148

Job title	Respondents
Audit Committee Members	104
Non-Audit Committee Members	44
Total	148

Country	Respondents
Americas	47
Brazil	5
Canada*	17
US	25
Asia	32
Australia & New Zealand*	17
China & Hong Kong	4
India	5
Singapore	6
Europe	69
France	11
Germany	6
Italy	8
Netherlands	9
Poland	4
Russia	5
Sweden	9
Switzerland	9
UK	8
Total	148

* Responses in Australia / NZ and Canada weighted down to be aligned with comparable markets

Industry group	Total
Financial Services	30
Industrial Products	29
Energy, Chemicals & Utilities	20
Technology, Communications & Entertainment	19
Retail & Consumer Products	16
Services	11
Real Estate, Hospitality & Construction	6
Transportation	3
Health Sciences	2
Other Industries	12
Total	148

¹The telephone-based survey was conducted by Taylor Nelson Sofres, London.

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