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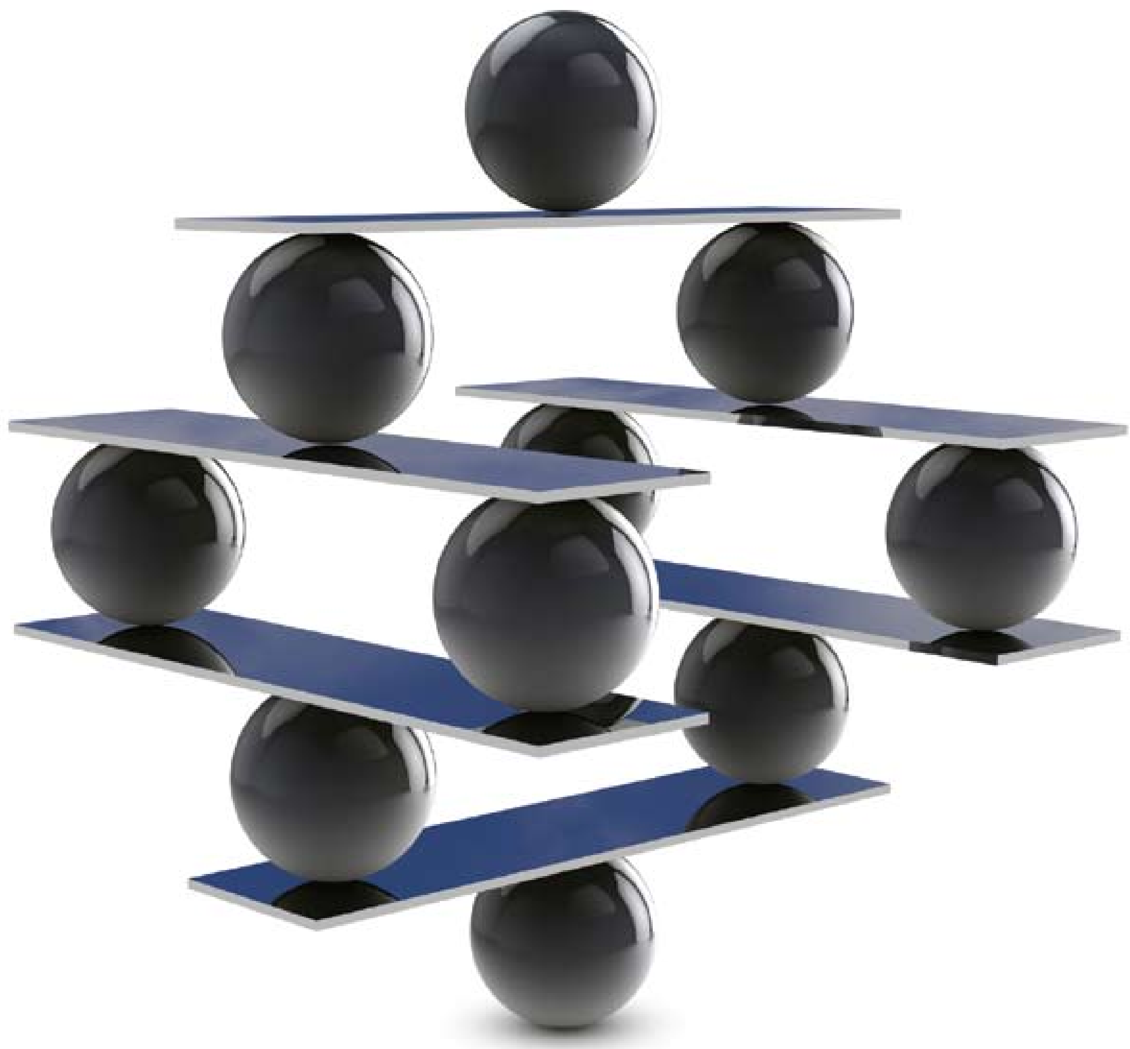
Risk Intelligence in a downturn
Balancing risk and reward in volatile times



Risk Intelligence Series
Issue No. 14

Preface

This publication is the 14th whitepaper in Deloitte's series on Risk Intelligence. The concepts and viewpoints it presents build upon those in the first whitepaper in the series, *The Risk Intelligent Enterprise™: ERM Done Right*, as well as subsequent titles.

The series includes publications that focus on roles (*The Risk Intelligent CIO, The Risk Intelligent Board,* etc.); industries (*The Risk Intelligent Technology Company, The Risk Intelligent Energy Company,* etc.); and issues (*The Risk Intelligent Approach to Corporate Responsibility, Risk Intelligence in the Age of Global Uncertainty,* etc.). You may access all the whitepapers in the series free of charge at **www.deloitte.com/RiskIntelligence**.

Unfettered communication is a key characteristic of the Risk Intelligent Enterprise. We encourage you to share this whitepaper with colleagues – executives, board members, and key managers at your company. The issues outlined herein will serve as a starting point for the crucial dialogue on raising your company's Risk Intelligence.

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Foreword

"We don't have time for risk management," protested one line manager recently when we brought up the subject. Words to make a senior executive or board member cringe – especially in a turbulent economy. With the recession heightening risk[1] on all sides, the last thing a company needs is for stressed-out employees to dismiss risk management as nothing but a costly, compliance-focused chore.

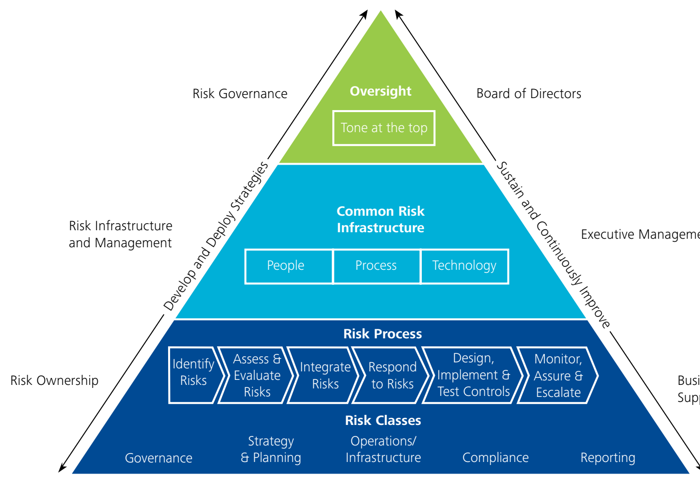
In fact, as most senior leaders know full well, current economic stressors call for greater attention to risk management than ever. Low consumer demand, limited access to credit, capital markets volatility, the impacts of the global recession – all these and more can raise exposures far beyond acceptable limits if they're not thoughtfully addressed. What's more, staff and budget cuts may have thinned out your company's capabilities for managing risk just when they are needed most.

We believe that the concept of the Risk Intelligent Enterprise™ has much to offer leaders as they strive to manage risk under these challenging conditions. According to the Risk Intelligent Enterprise framework, effective risk management depends on three key components:

- Risk *governance*, including strategic decision-making and risk oversight, led by the board of directors
- Risk *infrastructure and management*, including designing, implementing, and maintaining an effective risk program, led by executive management
- Risk *ownership*, including identifying, measuring, monitoring, and reporting on specific risks, led by the business units and functions

Activities across all these levels are integrated into a systematic, enterprise-wide program that embeds a strategic view of risk into all aspects of business management, and that gives leaders a clear view into the challenges and opportunities that risk can create.

The Risk Intelligent Enterprise™



This whitepaper discusses a sampling of the issues at all three levels that the leaders of a Risk Intelligent Enterprise may need to consider as they manage risk in the downturn. Though by no means comprehensive, we hope that it gives you a flavor of the perspectives that Risk Intelligence can bring to the risks associated with the recession – and the challenges of managing them effectively within stringent economic constraints.

As the events behind the downturn have made crystal clear, risk management is a fundamental driver and preserver of enterprise value. We believe that Risk Intelligence can be a useful guide to business leaders in their efforts to protect and enhance value through effective risk management – both during the recession and through the recovery.

The director's cut: Oversight in action

In this age of board-level accountability, board members are taking their oversight role over risk management very seriously – and asking searching questions about how best to accomplish it. We've highlighted a number of considerations for boards in sidebars like this one throughout the text, which dig a little deeper into selected issues in risk management governance and oversight (as opposed to execution) that boards may face as they help companies manage risk through the recession. Readers looking for a fuller discussion of the board's risk management governance and oversight responsibilities will find it in our whitepaper *The Risk Intelligent Board: Viewing the World Through Risk-Colored Glasses.*[2]

[1] Following the definition used in previous whitepapers on the Risk Intelligent Enterprise™, we define risk as the potential for loss or harm – or the diminished opportunity for gain – that can adversely affect the achievement of an organization's objectives. Classes of risk include risks related to governance, strategy and planning, operations and infrastructure, compliance, and reporting – each of which encompasses a multitude of categories, sub-categories, and specific risks.

[2] Available online at www.deloitte.com/RiskIntelligence.

Part one: Keeping your balance

Risk Intelligence is all about maintaining the right balance between risk and reward. Here are some ways you can help your company keep its balance in the face of today's economic challenges.

Staying aligned

A downturn can drive such rapid changes in business priorities that the thinking around risk has a hard time keeping up. That's why leaders in a bad economy need to be especially vigilant about aligning business goals with risk management objectives. Let them slip too far out of alignment, and your company could wind up taking either too much or too little risk to effectively pursue its goals.

Company leaders can unwittingly encourage excessive risk-taking if they recalibrate business priorities without fully considering whether the new priorities are consistent with the company's risk appetite. If the new goals entail a level of risk outside leadership's comfort zone, or if they're communicated without a clear statement of the risk parameters, people may take unacceptable chances to pursue those goals in the sincere belief that they're acting in the company's best interests.

A disconnect in the other direction can be just as damaging. A risk appetite that's too conservative for the times can unduly limit a company's options in a turbulent economy. To act effectively today, a business may well need to accept a level of risk that leaders might have considered excessive a year or two ago.

It's up to senior executives, as corporate strategy-setters, to resolve such inconsistencies. This doesn't mean getting down in the weeds to personally review every decision that could affect risk exposure. Rather, executive leadership's job is to take a broader view of risk in the context of business strategy, and then to set, communicate, and enforce a consistent set of risk and business objectives that make sense for the company's current needs.

The rate of change in a downturn can outpace risk management adaptations even at companies that manage risk well under "normal" circumstances. So even if you don't think you need to, consider taking a close look at your business goals and your risk management priorities to make sure they're working with, not against, each other.

The director's cut: Focused communication

To properly monitor alignment between strategy and risk management, boards of directors need to maintain a continuous stream of communication with senior executives. How can board members structure that communication so as to be confident that they're keeping abreast of important issues – without being overwhelmed by details that are more properly left to management?

One approach that we find works well is to periodically identify, assess, and update a "master list" of key strategic, operational, and compliance risks that are important to both value creation and value preservation. The board can then set thresholds to indicate the point at which they expect executives to bring each risk to the board for discussion. Establishing these parameters in advance can make risk-related communication between boards and executives much more effective than an ad-hoc approach.

As part of this periodic monitoring of risk, boards should be provided with an analysis of how key risks have moved over time. Layering the periodic reports over one another will help identify trends, which can help board members better understand how the company's risk profile is changing, provide an early warning signal for "bet the company" risks that start out relatively small, and foster an improved dialogue about the drivers of risks. If management provides the context for why a risk has shifted from period to period, the board will better understand the root causes of risk that they should be aware of in the future.

Risk-seeking ≠ recklessness

Is all risk bad? No! One of the most basic tenets of Risk Intelligence is that companies need to take calculated risks to build business value. That doesn't change in a downturn; in fact, as we've just said, a greater willingness to take such "rewarded" risks may be just what a company needs to make it through.

There's a big difference, though, between being willing to take risks and being reckless. And unfortunately, the high-stress environment of a recession can blur the distinction. A sense of crisis can skew people's perceptions of the needs, the stakes, and the alternatives. Demands to act *now* can lead even seasoned executives to make snap decisions. Throughout the organization, risk management processes and procedures can take a back seat to gut feelings and precipitate action.

Boards and senior executives have a dual role in upholding a company's discipline around risk-taking. First, they need to stand firm against pressures to make decisions before they have enough time and information to think through the risks. It's important to balance the need for timely action with the need to carefully evaluate each opportunity against the risks. Discussions with fellow business leaders can help executives weigh the potential upsides against the potential downsides, as can a clear definition of the company's risk appetite (see sidebar).

Second, business leaders should be diligent about communicating their risk management objectives and appetite to the rest of the organization. Senior executives should meet with functional and business-unit leaders to clarify the board's expectations around risk management, holding them accountable for managing risk according to the board's expectations and – as far as possible – giving them the tools and resources they need to execute.

Changing a company's risk-taking behavior is a perfectly legitimate business decision. Just be careful that any changes that occur take place by decision, not by default.

The director's cut: Defining risk appetite

It is virtually impossible for a board to execute its risk oversight responsibilities without both understanding the process management has employed to define the company's risk appetite and agreeing with the outcome of that process. Boiled down to its essentials, defining a company's risk appetite entails developing a formal statement of the extent and types of risks that are acceptable for a company to incur in the pursuit of its strategic goals. To effectively guide an organization's risk management activities, a risk appetite definition should:

- Establish common standards and metrics for evaluating risk. One approach would be to define both quantitative and qualitative criteria for rating risks as "high," "medium," and "low" along the dimensions of impact, organizational vulnerability, and speed of onset (see page 15).
- Define risk tolerance thresholds and related controls. Policies such as "Actions that incur risks with an impact greater than $50,000 on net operating profit must be approved at the vice-president level" specify the actions to be taken with regard to particular levels of risk, allowing a company to put its risk appetite philosophy into practice.

One important aspect of the board's oversight would be to understand the scope of the risks management has considered in developing the risk appetite. A strong risk appetite definition will encompass a broad range of enterprise risk classes, including governance, strategy and planning, operations and infrastructure, compliance, and reporting risks. Within each of these general areas, a number of specific risk categories (e.g., financial risk, supply-chain risk, R&D risk, tax risk, talent risk) may be identified and prioritized based on corporate strategy.

Beware the bargain-hunters

Buying up businesses at a discount can be a real opportunity in today's depressed markets. Play your cards right, and you could become the proud new owner of that promising enterprise or distressed competitor that you've been eyeing – at a fraction of the pre-downturn price.

The flip side is that, if your company's in good enough shape to go bargain-hunting, there's a fair chance that it could itself be targeted by bargain-hunters. And that puts you at risk of experiencing changes in company ownership, whether through an outright takeover or by opportunistic investors taking advantage of low stock prices.

It's natural to think that the general slowdown in M&A and investment activity makes it less likely that you'll be taken over or experience significant shifts in ownership. Don't. Your company's specific risk of ownership change depends much more on the state of its balance sheet and the interest of potential buyers than on overall market trends. In fact, because a bear market may attract short-term investors whose goals differ significantly from those of long-term investors and management, a downturn can make it even more important to monitor changes in ownership to help you prepare for any actions those new investors may take. The risk of unwelcome activity by new shareholders can make this a good time to strengthen relationships with your current long-term investors. Over the past few years, increasing shareholder activism has sparked a trend towards more open, two-way communication with shareholders on everything from board leadership and governance to executive compensation and strategy. Reaching out to shareholders now can help you consolidate your understanding of their expectations in these turbulent times and build relationships to draw upon in the future.

So keep close track of who's holding your company and what their agendas might be. Otherwise, you could unexpectedly find yourself on the receiving end of someone else's rewarded risk-taking – whether you like it or not.

The director's cut: An outside view

Representing shareholders' interests, as a board of directors is bound to do, can be especially challenging when a takeover offer is on the table. A change in ownership interest that offers substantial short-term gains may be very attractive to executive management – but boards acting on behalf of current investors need to evaluate how the deal may affect long-term value creation as well. Conversely, management may be slow to recognize the prudence of a fair offer that is in the interests of the shareholders.

To protect themselves against possible scrutiny, boards should take care that their processes for considering potential transactions are truly independent of management's evaluation processes, incorporating outside information sources as well as management input. The time to shore up such processes is now – *before* an offer presents itself. Boards may wish to work with both internal and external advisors to see that appropriate leadership and processes are at the ready and to verify that all members of the board understand their fiduciary duties – and how those might change in the event of a significant transaction.

The face of the company

When push comes to shove, the public responsibility for risk management rests with senior executives with active oversight by the board. And as intense as scrutiny was when the economy was good, the downturn has ratcheted up expectations around risk management to an unprecedented level. Wary investors are demanding greater transparency into risk; many observers are speculating about the likelihood of new risk disclosure regulations (or at the very least, stronger enforcement of the existing rules). Meanwhile, the unstable economy makes it more likely that a company will experience the kinds of risk events, from missed earnings targets to ethics breakdowns, that can force business leaders into a highly uncomfortable public spotlight.

What can a Risk Intelligent leader do to manage public perceptions? Here are some steps to consider:

- **Take a fresh look at the company's risk disclosures.** Suffering a loss is bad enough, but claims that a company didn't adequately disclose the risk to its stakeholders will most certainly make the situation worse, particularly for directors and officers that sign the company's public filings. Reduce the company's vulnerability by examining the quality of its risk disclosures, particularly those in the Management's Discussion and Analysis section of the Form 10-K. Do the disclosures include all of the risks that management and the board spend time deliberating (recognizing the need to protect competitive information)? Are they deep enough to give users a real sense of the issues and the potential impact? For risks that can be quantitatively measured, does the company provide sensitivity analyses to help users understand the specific impact of particular changes in circumstances? If the answer is no to any of these, consider rewriting the disclosures to address these issues.
- **Prepare for crisis management.** Reputation is a huge part of business value – and the way business leaders engage with the public in the heat of a crisis may affect reputation for years after the dust settles on the crisis itself. It's prudent to prepare a crisis response plan in advance that establishes clear constructs for board leadership and appropriate legal responses, as well as a PR plan to help leaders manage the image side of the equation. That way, when the unthinkable happens, leaders will be much better positioned to advocate the company's case to the public, reduce senior management distraction, and work as a cohesive team towards resolution.
- **Examine your whistleblower response processes.** Having solid protocols for investigating whistleblower allegations are important under any circumstances. In a downturn, though, those follow-up protocols may get more of a workout than in an economic climate less conducive to fraud. Evaluate your contingency plans and regularly test their efficacy so that your company can mount a consistent, measured response to allegations of wrongdoing that complies with all procedural laws and regulations. Prior planning in this area can help protect your company against the regulatory, legal, and public-relations fallout of a mishandled investigation.

Efforts like these aren't focused on creating media spin. They're focused on strengthening the risk management substance a company needs to deal effectively with unusual events – which, in our view, is far more effective in protecting reputation than spin alone. Because when it comes to public perception, it's hard to improve on the advice Socrates is said to have given more than 2,000 years ago: "The way to gain a good reputation is to endeavor to be what you desire to appear."

The director's cut: An heir and a spare

One downturn-driven risk of particular concern to boards relates to the possible need, due to intense public scrutiny in troubled times, to replace the CEO or other top executives in a hurry. Standard succession planning processes may not be enough to fill this need; shareholders may reject the board's first choice, for example, or the leading internal candidate may also unexpectedly leave. Exploring several succession options suitable for a variety of different circumstances can reduce the risk of a meltdown in case the need for an emergency replacement arises.

Work smarter

For many companies, a recession means having to cut costs, sometimes drastically. As realists, we're not going to argue that you should exempt risk management from the knife – but we do want to stress the importance of preserving risk management effectiveness as you look for ways to control costs. Fortunately, if your company is like most, risk management can offer many cost-reduction opportunities that can not only maintain, but actually *improve* effectiveness.

Here's why. Unlike areas such as production and supply chain that were heavily targeted by past "reengineering" projects, many company's risk management processes are still a product of historical accretion, with various groups layering on tests, reports, and oversight procedures as regulations emerge and risk management priorities evolve. The frequent result: redundant, overlapping functions, processes, and controls that not only waste time and money, but whose complexity increases the risk of errors and inconsistencies. Add to this the widespread use of spreadsheets, manual processes, and incompatible systems, and it's no wonder risk management often costs more than business leaders would like … and offers so much room for improvement in both cost and performance.

Few departments provide a better example of this than many tax departments. At many companies, inefficiencies in the accessibility, management, and retention of complex cross-enterprise accounting information can create significant duplication of effort between the tax compliance and provision processes. Improvements in this area can lead to impressive gains in efficiency as well as reduced risk. One global energy company, for example, was able to reduce both the time spent on tax provision, compliance, and controversy processes and the risk of error by creating a single centralized data file to support those processes.

With the downturn making cost control a priority, you may decide that your company can't afford *not* to start rationalizing risk management processes now. All activities related to monitoring, assessing, and responding to risks are fair game, including processes related to risk assessment, internal controls testing, compliance, and so on. Explore how you might be able to take advantage of common elements among regulations and existing internal programs, and break down organizational silos to look for commonalities among processes managed by different areas of the business. The benefits of your newly efficient processes can be multiplied with technology, such as workflow applications, automated controls, or a common database, that makes it easier for people to find information and follow the rules. You may not even need to spend much on new technology; many companies we've worked with are pleasantly surprised to find that they already own "shelfware" – software capabilities, such as ERP or IT management platforms, that were installed but never used – that can support their updated risk management processes.

The magnitude of the effort doesn't have to stand in the way of improvement. You may be able to find areas of low-hanging fruit that can yield substantial results with a modest up-front investment. Even if the savings from any particular change may be small, it's quite possible that you can make enough of those small changes to have a large aggregate impact.

Although cost reduction may be the impetus for rationalization now, we think that it's an effort worth continuing even after the economy recovers. A streamlined, standardized risk management infrastructure, buttressed by appropriate technology, can deliver long-term benefits far beyond immediate cost reductions: greater transparency, greater cross-enterprise collaboration, and, ultimately, greater business value.

The people behind the processes

Headcount reduction deserves special mention as a cost-control move that can have especially significant risk management implications. This applies to headcount reductions everywhere in the business, not just in formal risk management functions such as internal audit and compliance.

Obviously, it's important to reduce headcount in a way that preserves coverage for core processes. Risk management processes, however, can be trickier to preserve than those in many other areas. Just figuring out who's responsible for what can be a challenge if risk management responsibilities aren't clearly defined and documented. Without guidance on key risk-related positions and tasks, department heads and supervisors – especially in functions like HR, IT, and operations where people tend to be less risk-aware – may not understand (or care about) the risk management impact of eliminating certain jobs or reallocating certain responsibilities. We've seen well-meaning department heads remove an entire "redundant" layer of management without realizing that that level owned a key control activity, substantially increasing the company's risk exposure in one fell swoop.

The danger is all the greater because risk management process gaps aren't always immediately apparent. An increased potential for harm is easy to miss if you're not specifically looking for it – until it blows up as an actual risk event.

Awareness, clarity, and communication are your main safeguards against making personnel cuts that unwittingly sabotage risk management effectiveness. Everyone in a position to make headcount-reduction decisions, from senior executives down to the lowest rung of management, should understand the need to take risk management into account. (This doesn't mean that risk should preempt other factors, just that it should be considered on an equal basis.) The same goes for anyone who might need to reallocate responsibilities after a layoff or reduction in force.

For people to act on this awareness, they need to clearly understand the risk management processes, roles, and responsibilities under their jurisdiction. If you can't get enough clarity on this to offer useful guidance, now is an excellent time to start codifying at least some of the basics. Map out your company's risk management processes, decide which positions should be responsible for which tasks, and write those responsibilities into each position's job description. Formalizing and documenting these roles and responsibilities will help you not just make better headcount-reduction decisions now, but manage risk more effectively in the long term.

Communication, the third safeguard, is your tool for driving both awareness and clarity throughout the organization. Foster awareness by asking your managers to explain how their headcount decisions will affect risk management. Improve clarity by asking them to review their department's risk management roles and responsibilities as part of the headcount-reduction process. For managers in especially sensitive areas, such as finance, you may even want to send someone to go over the details with them in person.

In the "people, process, and technology" trinity of risk management infrastructure, it's the people who ultimately make the other two work. Careful attention to the people piece is an important part of defending your company against unnecessary risk.

Fighting fraud at the source

History suggests that fraud increases in a downturn.[3] Why?

Weaknesses arising from cutbacks in anti-fraud programs and controls are part of the reason, of course. But more fundamentally, it's because the stresses of a downturn can drive good people to do uncharacteristically bad things. Pressure to meet unrealistic business objectives or deadlines, according to a 2005 Ethics Resource Center study, is the top factor that leads people to compromise their ethical standards, with the desire to protect one's livelihood and a cynical, demoralized working environment not far behind.[4] And if there's anything a downturn can supply in abundance, it's unrealistic pressure, threats to one's livelihood, and cynicism and demoralization.

The good news is that you may be able to do a great deal to reduce these pressures at your company. One way to start might be to critically evaluate the company's financial goals, adjusting them as needed to reflect a realistic view of the circumstances. A related step could be to examine the way your company determines compensation, both for management and for the rank and file, to change any aspects of the system that encourage a "results at any cost" attitude. Consider establishing performance and compensation metrics that take skill and behavior into account as well results. This can not only reduce the motivation for fraud, but also help the company avoid false positives – that is, people whose strong skills are masked by downturn-driven poor results – when looking for underperformers to cut.

On a more personal level, a useful tactic can be to educate supervisors to be more sensitive to work-related strains among their direct reports. Train them how to make headcount reductions with respect, and remind them to try not to overload the survivors with work. You can help them with the latter by eliminating low-value activities and redesigning inefficient processes to reduce total workload, both of which you may be doing anyway as a cost-control measure. (Of course, as we mentioned earlier, it's important to preserve the execution of key control responsibilities while making workload adjustments.)

When it comes to morale, remember that honesty really is the best policy, even if it means being honest about having to freeze salaries, eliminate bonuses, or let people go. For extra impact, accompany communications about what you're doing with a thoughtful discussion of why – one that goes beyond a generic "times are tough." (If you're closing a plant, for example, explain why you've chosen to close that particular plant at that particular time.) Your people may not always agree with you, but they'll likely be more accepting of change than if they think you're trying to cover things up.

The pressures of a downturn can contribute to a state of mind where it's easy to justify unethical behavior. The more you can do to mitigate these pressures, the less likely your people will be to seek a way out through fraud.

[3] Ben Levisohn, "Experts Say Fraud Likely to Rise," *Businessweek*, January 9, 2009. Accessed January 28, 2009 at http://www.businessweek.com/bwdaily/dnflash/content/jan2009/db2009018_753877.htm.

[4] S. Baviskar, P. J. Hamed, and A. L. Seligson, National Business Ethics Survey 2005, Ethics Resource Center, 2005, cited in American Management Association/Human Resource Institute, *The Ethical Enterprise: Doing the Right Things in the Right Ways, Today and Tomorrow – A Global Study of Business Ethics 2005-2015,* 2006.

The director's cut: Spotlight on executive compensation

It's widely recognized that the way executives are compensated can have a large impact on their risk-taking behavior – and therefore on a company's risk exposure. In fact, the American Recovery and Reinvestment Act of 2009 (ARRA) explicitly states that, among recipients of Troubled Asset Relief Program (TARP) funds, executive compensation must be structured so as not to encourage executives to take "unnecessary and excessive risks."[5] While this legislation applies only to TARP recipients, the principle behind it holds true for any company: Executive compensation should align with solid risk management practice.

The current public focus on the issue can give boards the opportunity to examine how well their approaches to executive compensation support a company's risk management objectives as well as its broader strategic goals. Questions to consider might include:

- *Over what timeframe should an executive's contribution be measured and rewarded?* At many organizations, executive compensation emphasizes the achievement of short-term results, which can entail greater risks than the pursuit of long-term goals. Adjusting compensation schemes to balance short- and long-term considerations more evenly is one way to encourage executives to view risk-taking from a longer-term perspective.
- *How can we encourage a more comprehensive approach to executive decision-making?* All companies operate within a decision-making hierarchy, but prudent decision-makers solicit a wide range of input, including "bad news," to inform their choices. In addressing risk, executives must take care to hear and consider many voices, even those that challenge their own assumptions.
- *How should we define the value that an executive brings to the enterprise?* A pay-for-performance model that recognizes only financial performance can lead to extreme swings in compensation for reasons that have more to do with the general economy than with how "valuable" an executive is to an organization. In addition, performance models based primarily on financial metrics can encourage precisely the kind of accounting sleight-of-hand that is at the heart of most financial frauds. While contribution to financial performance is definitely an important component in defining value, it is also important to factor in an executive's skill, knowledge, effort, and behavior. Taking these items into account creates a deeper understanding of the short- and long-term value that these individuals contribute to the company.
- *What contractual obligations are we committed to?* Often, boards are caught unawares when executives receive bonuses during periods of poor financial performance or upon their termination from the company. Inventory such obligations now and, if necessary, consider alternative ways to compensate key talent that reduce the reputational risk involved in some of these more unpalatable bonus plans.
- *What are the most subjective financial drivers of executive compensation?* Most pay-for-performance compensation arrangements rely, at least in part, on reported financial results. However, there are, and always will be, certain areas of reported financial results that are more subjective than others. When those subjective areas drive executive compensation, heightened scrutiny may be warranted. Understanding the pressure points inherent in compensation arrangements, and maintaining appropriate oversight over those areas, is a logical step for boards seeking to better coordinate the construction of compensation schemes with their oversight of financial reporting.

[5] For more information on the ARRA's executive compensation rules for TARP recipients, which include an executive compensation tax deduction limitation; restrictions on bonuses, retention awards, and golden parachute payments; and additional executive compensation governance standards, see our publication *The New Executive Compensation Restrictions*, available online at **http://www.deloitte.com/dtt/article/0,1002,sid%253D26554%2526cid%253D250425,00.html**.

The truth about talent

Talent management doesn't usually strike business leaders as a significant downturn risk. High unemployment rates and a moribund job market can make leaders feel more secure about talent than they have for a long time.

Talent challenges don't disappear in a downturn, however. They just come from different directions than you might be used to.

For example, even though overall turnover rates may have dropped, a bad economy can raise the risk of losing a disproportionate number of your *top* performers. Companies often assume that the relative lack of alternatives will help them retain their people in the face of cost-control measures that make their organizations a less attractive place to work. But while this may be true for most employees, top performers, even in a downturn, usually have more employment options than the average worker. Which means that, even if most of your people don't have the opportunity to leave, those that do will probably be the ones you most want to keep. For this reason, some employers are considering offering retention bonuses to employees they particularly need to retain – and from whom they are asking more.

Unexpected risks can also arise from too much of a good thing. For example, many Baby Boomers who were planning to retire at around this time can't afford to do so until their investments recover. But while many companies are glad to hold onto the Boomers' valuable accumulated skills and experience, the fact that they tend to occupy high organizational ranks can lead to dissatisfaction among ambitious younger employees who view the Boomers above them as a roadblock to their own advancement. Phased retirement programs, designed to allow the older worker to access some retirement savings while continuing to work part-time, can be one way to facilitate Boomer retirement even in a difficult economy.

Then there's the risk of making ill-conceived headcount reductions that ultimately increase, not decrease, your costs. This usually happens when a company realizes that it needs to bring back former employees as consultants to take care of tasks only they know how to do – at a higher cost than if it had kept them on the payroll all along. Less obviously, headcount reductions can also raise costs associated with severance and extended health benefits, qualified plan discrimination testing, and new hire re-training, making it advisable to model the savings and costs of reductions before making cuts.

The outlook isn't all bad, though. In fact, talent is one area where the downturn can increase the potential payoff of taking rewarded risks. There is little need for companies to accept marginal performance from key corporate or divisional managers when so many talented people are looking for work. We know of more than one company that is considering options for upgrading their teams as part of their periodic management performance assessment process.

For all these reasons, talent should be just as great a concern now as it was when labor was scarce. The issues may be different, but they're equally worthy of your attention.

Tax risk: More than just compliance

Adapting to a downturn can mean making significant changes to a company's global footprint, worker deployment, and other aspects of operations. These changes often have implications for risk – and reward – in an area many companies overlook: tax.

Building tax considerations into the decision-making process can do much more than support tax compliance. Downturn-driven business decisions often have tax implications that affect not only compliance, but the overall value of the options on the table. For instance, if a company is considering reducing its presence in one or more jurisdictions, proper attention to the tax implications can clarify the tax costs or benefits of each alternative under consideration. This allows leaders to evaluate the potential cost savings on an after-tax basis, which can be quite different from the "savings" computed without taking tax into account.

When making changes in areas that have highly complex tax implications, companies need to be especially careful in understanding the rules and managing activities in a way that both complies with tax law and avoids unnecessary costs. A good example of one such area is global workforce management. Because international assignments create a host of tax implications for both the mobile employee and the company, changing any aspect of a global mobility program is likely to affect a company's tax position in complex and sometimes unexpected ways. For instance, a company that decides to reduce the use of long-term assignments in favor of short-term ones will need to understand and address the differences in various countries' tax treatment of long-term and short-term expatriate employment.

Besides clarifying the tax implications of downturn-driven business decisions, savvy tax management can also help increase a company's cash flow. International tax planning can provide opportunities for accessing cash trapped overseas through repatriation strategies. Examining transfer pricing policies can identify potential changes that can improve cash flow, reduce the risk of U.S. and foreign tax adjustments, and correct unintended results that cause spikes in effective tax rates. And in the U.S., examining tax accounting methods and applying for permission to change methods with the IRS may result in refund claims for cash taxes paid – or at least allow a company to better manage taxable income while continuing to manage existing tax risks, including financial reporting risk.

Tax can play a crucial role in virtually every strategy a company may pursue in response to the downturn. Early and frequent involvement by tax can help companies avoid expensive tax mistakes and identify tax savings opportunities.

We're all in this together

Because a general downturn affects everyone you do business with – suppliers, customers, channel partners, alliance/joint venture partners, and so on – the risks associated with those relationships can be substantially higher today than they were when you formed or last reviewed them. Even a company's own foreign subsidiaries can be affected in unexpected ways during a global recession; it can be even harder to identify and deal with changes at external parties. That's why many management teams today are taking stock of their governance over such relationships, assessing the risks, and creating new monitoring controls to manage them.

Besides the outright failure of a value-chain partner, a recession can also drive more subtle dangers to the extended enterprise. One potentially significant risk, for instance, is that a supplier may try to cut costs by relaxing its standards around product quality or safety, passing the substandard material or component – along with the attendant risk – to your unsuspecting organization. This risk can be especially high at companies that source materials from developing countries, where regulations tend to be looser and less strictly enforced. Not knowing it was happening is no excuse: Legal and regulatory bodies, to say nothing of public opinion, could easily argue that you should at least have considered the possibility.

Remember, too, that the impact of a risk event is not necessarily tied to the monetary value of the business relationship. You may only buy a few tens of thousands of dollars' worth of components from a particular vendor, but if those components go into 90 percent of your products – and if that vendor is your sole supplier – your risk is much bigger than the size of the contract would suggest.

Don't forget that the organizations you deal with directly have relationships of their own that could affect your company's risk profile. Sourcing a component from three different vendors won't reduce your supply-chain risk if all three vendors buy *their* key component from the same company.

Business relationships today are more complex and more pervasive than they've ever been. In this multiply connected world, following the connections a step or two beyond the obvious can go a long way toward avoiding unpleasant surprises.

This too shall pass

The best thing about the downturn is that it'll eventually end. Here are some ways that you can help your company make a Risk Intelligent recovery.

The first point concerns a basic but vital housekeeping duty. In spite of your best efforts, the realities of a tough economy may force you to compromise on some aspects of risk management. And as we've mentioned before, risk management weaknesses have a way of going unnoticed unless a company is expressly looking for them. So make it a point to reexamine your risk management processes for areas that might have been adversely affected by the downturn. Risk assessments and gap analyses can help you prioritize which areas should be addressed first. Look at places where you didn't make cuts as well as places where you did; you might be surprised at the unanticipated impact that changes in one part of the business can have on another.

Another point relates to the well-worn advice not to cut so deeply during the recession that it cripples your ability to act on the recovery. Translate this platitude into actionable insight by exploring various scenarios for the upturn, identifying which parts of your company the upturn is likely to put stress on first, and making plans for relieving those stresses as they happen. Better yet, incorporate this exercise into your cost-control decisions to begin with – it'll help bring a valuable longer-term perspective to your plans for meeting your company's more immediate needs.

Finally, to echo what we said in the first chapter, remember to cross-check for alignment between your business and risk objectives as the economy turns around. Just as a pre-downturn view of risk can be unsuitable for your company right now, a downturn-centric view of risk can quickly become out of date in a period of recovery.

The director's cut: A focus on process

Regardless of the state of the economy, it's worth remembering that legal, regulatory, and leading practice frameworks have historically placed more emphasis on the board's responsibility for understanding risk management *processes* than on its responsibility for the actual outcomes of those processes. Negative business outcomes don't necessarily reflect weak risk management or a lapse in board oversight – and positive outcomes don't necessarily reflect strength in either area.

To protect itself, a board must do more than evaluate the output of management's risk management process or the business outcomes that the process informs. It must also consider the adequacy of the process itself, preferably by measuring it against those of peers or leading frameworks, as well as appropriately challenge key inputs and assumptions. Boards that do this well have governed well, even if the company's strategic choices ultimately fail.

Part two: What have we learned?

For all that a flawed understanding of risk may have contributed to the recession, a closer look at some of those flaws can point the way toward better risk management in the future. Here are some of our top candidates for the downturn's top risk management "lessons learned."

It's not impossible, it's just very, very improbable

Traditional risk management approaches prioritize mitigation actions based on the probability of risk events. That's one reason so many companies were blindsided by the recent financial crisis. The odds of the situation getting that bad that fast seemed so slim that few companies felt that they needed to plan for such an eventuality.

The issue is not just that improbable events sometimes happen. It's that the probability of many strategic risk events is not only unknown, but essentially unknowable. It's one thing to calculate probabilities when there are thousands or millions of data points to draw on, as banks and actuaries do on a regular basis. But what about the strategic decisions companies make when they push the boundaries, innovate, and pursue new outcomes? In many cases, the data needed to reasonably estimate the probability of those outcomes simply doesn't exist.

We encourage companies to look beyond probability when planning and prioritizing their risk management investments. Three factors we consider especially useful in evaluating risk are the *impact* of a risk event on business value, the organization's *vulnerability* to its effects, and the risk event's *speed of onset*.

Impact refers to the "raw" effect of a given event on your business – the degree to which that event, if it occurs, would affect enterprise value in the absence of any action you may take to either reduce its likelihood or mitigate its effects. In our view, responses to extremely high-impact risk events should be seriously considered no matter how unlikely they seem. This is not to say that companies should run themselves ragged in an attempt to identify every possible "bad thing" that can happen. But it does call for the response to be proportional to the impact of an event rather than its probability. If a major production facility becomes unavailable, it doesn't matter what causes the shutdown – a hurricane, a labor strike, or a terrorist attack. What matters is the damage the shutdown can do to the business – and, more importantly, the company's actions to prevent and/or respond to the situation. Vulnerability (residual risk) refers to the risk that remains after considering strategies and efforts to monitor, manage, and mitigate the raw impact. Taken together, impact and vulnerability can tell you how closely your risk management efforts match the actual risks your company faces. It can also help you fine-tune your risk management investments: High-impact risks to which your company is highly vulnerable may warrant an increased investment, while low-impact, low-vulnerability risks might benefit from a closer look to see if any resources could safely be reallocated elsewhere.

Speed of onset refers to the time it takes for a risk event to affect your business. It's important because it can help you judge the timing of your risk management investments: How far in advance do you need to prepare? Don't be surprised if your evaluation finds some risks with an almost immediate speed of onset: In a global economy with an effective 24-hour workday, the impact of a risk event doesn't break for sleep as it hurtles through the business community.

Together, impact, vulnerability, and speed of onset offer business leaders a much more nuanced guide to risk management than probability alone.

Smoking out the correlations

Modern portfolio theory, as devised by Harry Markowitz, holds that diversifying among uncorrelated risks can reduce portfolio risk towards zero. So why didn't it work to stave off the financial crisis? Simple: Correlated risks don't offer the same protection against risk exposure – and the financial instruments in play were so complex and so opaque that no one fully understood the interrelationships among their risks.

The lesson – watch out for hidden correlations! – applies equally well to risks of all types, not just the investment risks to which Markowitz addressed his theory. Recall our earlier example about the futility of managing supply-chain risks by sourcing from multiple suppliers if all the suppliers buy their key component from a single source. Such correlations can be not only difficult to spot, but troublesome to confirm: Even if you think to ask your vendors where they get their materials, they might not give you enough detail to be useful to your planning.

To make things even more complicated, interdependencies among risks often cross business-unit and functional boundaries. Attempts to mitigate risk in one area, such as operations, may affect risk exposure in other areas, such as finance. Or different areas of the business may independently pursue activities that, while remaining within each group's individual risk tolerance, create unacceptable risks for the company as a whole. Sometimes, organizational silos can mask important connections even in closely related areas. Many companies that were hit hard by the financial crisis, for instance, managed credit risk and liquidity risk in different parts of the organization – and were thus completely unprepared for the extent to which these risks fed into each other when the financial system began to unravel.

The ability to recognize hidden correlations depends greatly on integrating parochial perceptions of risk into an enterprise-wide view. One way to drive greater integration is to establish an enterprise risk management team positioned above the individual functions and departments. Have it look for interdependencies across organizational divisions as well as among your external business relationships. Senior executives can help jump-start the process by bringing together representatives from different business areas to share perspectives. Also, explore ways you can formalize cross-functional information exchange and practices for reporting to leadership, perhaps by consolidating risk and compliance management into a single organizational structure.

For every relationship between risks you see, there may be many that you've overlooked. Take advantage of the "enterprise" in enterprise risk management to help bring them to light.

Planning is just the beginning

Scenario planning – envisioning and planning responses to multiple possible futures – can be a powerful technique for helping companies anticipate and prepare for potential risk impacts. But planning, in itself, is only the beginning. Surprising as it may sound, we know of more than one case where a company used sophisticated scenario-planning processes to create impressive contingency plans – and then wasn't able to effectively carry them out.

One straightforward way to guard against such failures is to stress test your company's ability to execute on various contingency plans *before* you need to do it in real life. Evaluate the capabilities you'll need against your likely resources at the time, and think about how you can fill any gaps so that your organization can act if and when the occasion arises.

Just as important is to select the right "triggers" that can alert you that a particular scenario has become reality – and, even more important, to track and measure them with appropriate rigor. Subjective assessments ("Where do you think our competitors are these days?") and ad-hoc reporting ("Well, let me know when you think something's changed") are no substitute for data-driven metrics (both leading and lagging) and regular monitoring procedures. The latter may be more difficult to define and take more effort to keep up, but they're usually far more reliable as a call to action than an unsubstantiated opinion.

Planning ahead can make you feel more secure about risk events. Being able to recognize and act on the most important events puts substance behind the security.

The director's cut: Challenging assumptions

One important way the board of directors can add value to a scenario-planning effort is to identify and, if appropriate, challenge the assumptions upon which executive management has built the company's strategy and business plan. Recent history has taught that even assumptions that seem rock-solid – a continued rise in real-estate prices, a relatively stable interest rate – may break down under extraordinary circumstances. The intent of challenging such assumptions is not to impugn executive management's judgment, but to leverage the board's combined experience and perspectives to broaden the range of possible outcomes that the company has considered and appropriately planned for.

Examining a company's fundamental business assumptions can be an uncomfortable exercise. It forces leaders to ask themselves, "What if we're wrong?" – or, even worse, "What if we fail?" Yet to manage risk effectively, it's vital to not only admit the possibility of error and failure, but develop specific plans for dealing with error and failure should the need arise.

As an independent governance body, the board of directors is in a unique position to bring up the need for such planning to management – and to institutionalize a process of open, constructive dialogue that allows both boards and executives to raise tough issues in the pursuit of a common goal. One way to take the personal element out of the process is to appoint one or more directors to serve as "devil's advocates" during risk-related conversations. When these directors challenge management's assumptions, it should be understood that they are not launching a personal attack, but merely playing their assigned role. Of course, it helps if the directors selected are those that are well respected by management and the board and have no personal agendas or axes to grind.

Afterword

A down economy can make it hard to be as thorough about risk management as you'd like. The pursuit of Risk Intelligence, however, is one for all economic climates. As you manage through the recession, consider how you can encourage your business to systematically build risk management considerations into all of its downturn-related decisions. And when the economy starts to recover, take steps to build on your company's heightened awareness of risk to further establish Risk Intelligence as a way of corporate life.

The events of the recession have given dramatic evidence of how important risk management is to protecting and pursuing enterprise value. The Risk Intelligent Enterprise, while retrenching in the present, will do so in a way that strengthens its commitment to effective risk management – both now and in the future.

Nine fundamental principles of a Risk Intelligence program

1. In a Risk Intelligent Enterprise, a common definition of risk, which addresses both value preservation and value creation, is used consistently throughout the organization.
2. In a Risk Intelligent Enterprise, a common risk framework supported by appropriate standards is used throughout the organization to manage risks.
3. In a Risk Intelligent Enterprise, key roles, responsibilities, and authority relating to risk management are clearly defined and delineated within the organization.
4. In a Risk Intelligent Enterprise, a common risk management infrastructure is used to support the business units and functions in the performance of their risk responsibilities.
5. In a Risk Intelligent Enterprise, governing bodies (e.g., boards, audit committees, etc.) have appropriate transparency and visibility into the organization's risk management practices to discharge their responsibilities.
6. In a Risk Intelligent Enterprise, executive management is charged with primary responsibility for designing, implementing, and maintaining an effective risk program.
7. In a Risk Intelligent Enterprise, business units (departments, agencies, etc.) are responsible for the performance of their business and the management of risks they take within the risk framework established by executive management.
8. In a Risk Intelligent Enterprise, certain functions (e.g., Finance, Legal, Tax, IT, HR, etc.) have a pervasive impact on the business and provide support to the business units as it relates to the organization's risk program.
9. In a Risk Intelligent Enterprise, certain functions (e.g., internal audit, risk management, compliance, etc.) provide objective assurance as well as monitor and report on the effectiveness of an organization's risk program to governing bodies and executive management.

Additional resources

- *Managing the Business Risk of Fraud: A Practical Guide*, Deloitte Development LLC, 2008. Available online at http://www.deloitte.com/dtt/article/0,1002,sid%253D148424%2526cid%253D217567,00.html.
- *Risk Management in the Age of Structured Products: Lessons Learned for Improving Risk Intelligence*, Deloitte Development LLC, 2009. Available online at http://www.deloitte.com/dtt/article/0,1002,cid%253D228128,00.html.
- *Putting Risk in the Comfort Zone: Nine Principles for Building the Risk Intelligent Enterprise™*, Deloitte Development LLC, 2008. Available online at http://www.deloitte.com/dtt/article/0,1002,sid%253D109079%2526cid%253D223367,00.html.
- *Integrated Compliance and Risk Management: Rethinking the Approach*, Deloitte Development LLC, 2009. Available online at http://www.deloitte.com/dtt/article/0,1002,sid%253D2212%2526cid%253D247921,00.html.
- *Financial Fraud: Does an Economic Downturn Mean an Uptick?*, Deloitte Development LLC, 2008. Available online at http://www.deloitte.com/dtt/article/0,1002,sid%253D2007%2526cid%253D238194,00.html.
- *The Risk Intelligent Board: Viewing the World Through Risk-Colored Glasses*, Deloitte Development LLC, 2008. Available online at http://www.deloitte.com/dtt/article/0,1002,cid%253D222456,00.html.

Learn more about the Risk Intelligent Enterprise at www.deloitte.com/RiskIntelligence.

U.S. Contacts

Henry Ristuccia
U.S. Leader
Governance & Risk Management
Deloitte & Touche LLP
+1 212 436 4244
hristuccia@deloitte.com

Scott Baret
Partner
Deloitte & Touche LLP
+1 212 436 5456
sbaret@deloitte.com

Rita Benassi
Partner
Deloitte Tax LLP
+1 203 761 3740
rbenassi@deloitte.com

Donna Epps
Partner
Deloitte Financial Advisory Services LLP
+1 214 840 7363
depps@deloitte.com

Michael Fuchs
Principal
Deloitte Consulting LLP
+1 212 618 4370
mfuchs@deloitte.com

Bill Kobel
Principal
Deloitte & Touche LLP
+1 214 840 7120
bkobel@deloitte.com

Tim Lupfer
Director
Deloitte Consulting LLP
+1 212 618 4523
tlupfer@deloitte.com

Sandy Pundmann
Partner
Deloitte & Touche LLP
+1 312 486 3790
spundmann@deloitte.com

Nicole Sandford
Partner
Deloitte & Touche LLP
+1 203 708 4845
nsandford@deloitte.com

Stephen Wagner
Managing Partner
U.S. Center for Corporate Governance
Deloitte & Touche LLP
+1 617 437 2200
swagner@deloitte.com

International Contacts

Mark Layton
Global Leader
Governance & Risk Management
Deloitte & Touche LLP
+1 214 840 7979
mlayton@deloitte.com

Americas

Canada
Eddie Leschiutta
Partner, Enterprise Risk Services
Deloitte Canada
+1 416 601 5841
eleschiutta@deloitte.ca

Mexico
Walter Fraschetto
Partner
Deloitte México
+52 55 5080 6265
wfraschetto@deloittemx.com

United States
Henry Ristuccia
Partner
Deloitte & Touche LLP – United States
+1 212 436 4244
hristuccia@deloitte.com

EMEA

Belgium
Laurent Vandendooren
Partner
Deloitte Belgium
+32 2 800 2281
lvandendooren@deloitte.com

Commonwealth of Independent States (CIS)
Wayne G. Brandt
Partner
Deloitte CIS
+7 495 787 0600 x2922
waybrandt@deloitte.ru

France
Damien Leurent
Partner
Deloitte France
+33 1 4088 2969
dleurent@deloitte.fr

Germany
Joerg Engels
Partner
Deloitte Germany
+49 211 8772 2376
jengels@deloitte.de

Italy
Ciro Di Carluccio
Partner
Deloitte Italy
+39 06 3674 9325
cdicarluccio@deloitte.it

Netherlands
Wim Eysink
Partner, Enterprise Risk Services
Deloitte Netherlands
+31 65 141 7099
weysink@deloitte.nl

Spain
Alfonso Mur
Partner
Deloitte Spain
+ 349 1 514 5000 x2103
amur@deloitte.es

United Kingdom
Graham Richardson
Partner
Deloitte United Kingdom
+44 20 7007 3349
grrichardson@deloitte.co.uk

Asia Pacific

China
Danny Lau
Partner, Enterprise Risk Services
Deloitte China
+852 2852 1015
danlau@deloitte.com.hk

India
Abhay Gupte
Partner
Deloitte India
+91 22 6681 0600
agupte@deloitte.com

Japan
Masahiko Sugiyama
Partner, Enterprise Risk Services
Deloitte Japan
+81 3 4218 7283
msugiyama@deloitte.com

Singapore
Uantchern Loh
Partner, Enterprise Risk Services
Deloitte Singapore
+65 6216 3282
uloh@deloitte.com

#9040