The Risk Intelligent CFO

Converting risk into opportunity

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Preface

This publication is the 20th 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 a Downturn*, etc.). You may access all the whitepapers in the series free of charge at www.deloitte.com/us/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 the starting point for the crucial dialogue on raising your company's Risk Intelligence.

Introduction

The Board and C-suite are asking hard questions about risk. And they are seeking better processes to manage uncertainty in a challenging economic and regulatory environment.

Where do they turn? Increasingly, to the CFO — a voice of risk-related thinking; a catalyst, strategist, operator, and steward[1] with respect to risk decision making; and, in some organizations, the de facto chief risk officer.

Dealing with today's risks takes more than risk management. It takes *Risk Intelligence*. Given the comprehensive view available to CFOs — across balance sheets, corporate transactions, and the business — they are strategically positioned to recognize, manage, and report risks and opportunities to key stakeholders.

Building on this unique strategic perspective, the CFO can help educate the CEO, the management team, and the Board on the risks they face. By developing a more strategic vision and approach, the CFO can also assist the organization in taking the right risks — and taking the right amount of them.

Of course, creating a Risk Intelligent culture is neither easy nor foolproof, and no company is capable of mitigating or capitalizing on every risk that materializes. Instead, becoming a Risk Intelligent Enterprise™ requires a more practical approach: one that factors the consideration of risk into every strategy, decision, and activity, enabling the company to take advantage of the opportunities risks can create.

In the following pages, we offer some recommendations to help you do just that.

To learn more about embedding risk into decision making, see "Risk Intelligent Enterprise Management: Running the Risk Intelligent Enterprise™"

[1] Visit our **CFO Center** for additional information on the diverse and challenging roles CFOs play today.

Prepare for the expected; expect the unexpected

Action and escalation plans, monitors, and triggers may be in place for known risks. But unknown risks — those brought about by changing industries, markets, and strategies, as well as economic and environmental issues — often exist beyond what an organization might already be thinking about. So they are rarely spotted on the horizon.

This is not to say that only sudden events can catch you off guard. Slow-moving changes in customer interests, technology, and culture are also a threat, particularly when companies assume they can catch up to these changes later.

Developments and activities within the organization can blind-side a company as well. Time and again, businesses overlook internal problems, cut corners on safety, or become complacent about quality. Perhaps negative news travels upward too slowly, warning signals go unheeded, or the company is overly optimistic.

Need more to worry about? Unexpected, once-in-a-lifetime events occur more frequently than advertised. Oxfam reports that the "number of natural disasters has quadrupled in the last two decades."[2] In the past 30 years, the world has experienced four waves of financial crises. Or 20 stand-alone events, depending on your point of view.

Recommendation: Create comprehensive scenario plans.

CFOs should be vigilant in monitoring the environment for new risks and opportunities. They should also develop a process that assesses relevant, high-impact events — even if they are improbable — and then determine how quickly an event can happen and how swiftly they need to respond. Establish an "incident command system" to facilitate communication, preparation, and response. Keep communication channels open. Make sure bad news gets escalated. And don't become too comfortable with the status quo.

Expected risks also include future changes in regulation, tax, or accounting rules. For example, standard-setting changes are on the way, courtesy of both the Financial Accounting Standards Board and the International Accounting Standards Board. These changes will have significant impacts on financial results, operations, and other processes. Therefore, a Risk Intelligent CFO should instill a discipline that not only prepares for these new standards, but also allows all business units to consider how future events might affect current decisions.

[2] "Climate Alarm," Oxfam Briefing Paper, Oxfam International, November 2007.

Are you a Risk Intelligent strategist?

Most Boards and executives put significant effort into developing a strategic plan. But how robust is your process of identifying risks "to" the strategy — that is, recognizing and responding to threats that stand in the way of strategy execution? Obtaining financing for a new venture is one example of a threat "to" the strategy. Meeting product development deadlines to roll out a new product is another.

But leaders often have a blind spot with respect to a different type of strategic risk: the possibility that the strategy *itself* may be flawed. This is what we refer to as risks "of" the strategy, and they can be as dangerous as they are difficult to recognize. If the assumptions that underlie the strategy are changing or are no longer valid, the processes and policies that were built on those assumptions may become ineffective or even damaging. For the unprepared, the consequences could be fatal.

Recommendation: Recognize that your strategy is not iron-clad.

Regarding risks "to" the strategy, CFOs should engage executive management in strategic risk conversations around new products and alliances. The majority of executives see their jobs as growth — so it's vital that others in the C-suite understand that value and risk are inseparable and that opportunity is the other side of risk. Risks that impact value creation and future growth, as well as risks to value preservation and existing assets, should be considered.

As for risks "of" the strategy, make a practice of identifying any assumptions that could disrupt your strategy. What's looming that could upend assumptions about your company, customers, and market environment? How deeply are those assumptions embedded in your strategy? Which changing assumptions might actually turn out to be opportunities?

Only by identifying risks both "to" and "of" the strategy can you shape a plan that allows your company to make the most of the risks and the opportunities it chooses to take.

For more on risks "to" and "of" the strategy, see "Shaping a Risk Intelligent strategy: Confronting assumptions to find risk and opportunity"

Mailing it in

Consider the storyline of the media industry, particularly the video-rental business, and the movement of media from physical to mail to virtual. It's a tale that most of us are now familiar with: One media company recognized (and turned to its advantage) the risk "of" the strategy — that is, it challenged the widely held assumption that customers demand immediate access to products, and that physical storefronts need to be open around the clock.

By recognizing that the base assumptions had changed, the media company was able to change its business model, policy, and processes. Among its realizations: convenience trumps immediacy (why force customers to make a special trip to the store when their selected videos can simply arrive in the mail?); late fees are no longer necessary (the lure of the next movie in their queue is enticement enough to get customers to return DVDs); and subscription fees (in lieu of late fees) can be highly profitable.

But digital distribution of media presents an emerging risk "of" the strategy, and could disrupt the company's business model. With Internet streaming service, customers no longer need to choose between immediacy and convenience, and there's no more waiting for the mailman. A few details, though, still need to be sorted out, such as how quickly the media company (compared to its competitors) gets access to new movies; how it can compete with cable companies, computer companies, and others that are targeting the online streaming market; whether it will need to pay more for content (and how this might affect its pricing structure for customers); and whether customers will even embrace the streaming media offering (many have asked for a "DVD only" subscription option).

The sequel could be coming to a TV, laptop, or mobile device near you.

Distinguish between the "vital few" and the "trivial many"

You can't prepare for everything. So the question becomes: How can you determine — and act upon — what's practical and prudent?

It's not simply a case of identifying risks. It's about categorizing risks, aggregating risks, sorting the "vital few" risks from the "trivial many," and making those vital risks *matter*. The key risks, the value at risk, and specific processes should all be communicated to the organization. Who owns the issue? Who's taking action? How are the risks being monitored? Those are just a few questions that should be clarified as well.

To help focus on key threats and opportunities, four major risk categories — strategic, operational, financial, and compliance — can be viewed from a senior stakeholder's perspective. A number of organizations are also exploring the use of predictive analytics to help them determine which questions and which risks matter most, and to focus on the critical issues that need to be acted upon. Some of the top risk concerns that may affect companies include talent management, succession planning, monitoring and responding to the external economic environment, supply-chain interruption, and keeping tabs on changing customer demands for products and services.

Recommendation: Put signals in place and define thresholds.

By putting signals in place, CFOs can bring critical events, developments, and opportunities to the organization's attention — helping them distinguish between, say, 500 risks versus a list of five key areas to focus on. CFOs should also define thresholds and escalate problems if those thresholds are exceeded.

Is the Board on board?

Of course, the Board isn't the only stakeholder CFOs must answer to. Risk Intelligent CFOs consider risks from the perspective of all their stakeholders — regulators, shareholders, bondholders, counterparties, customers, and employees — as well as the Board.

Proxy statement disclosure requirements implemented in 2010 highlight the critical role of Risk Intelligence, as well as the critical responsibility of working with and across the Board. The rules mandate that Boards describe how they discharge their responsibility for risk oversight.

The call to work closely with the Board is nothing new. But the heightened expectations implicit in the disclosure rules have some Board members feeling vulnerable. Boards are looking for a better understanding of the processes management has in place for identifying, managing, and addressing risk under uncertain economic conditions. Boards may also look for additional education and advice on changing business strategies and risk exposures, as needed, to better position the company for the future.

Recommendation: Assume the role of risk educator.
CFOs should build involvement with the Board and key committees directly into their processes — from reporting and compliance to monitoring and managing risk. They should make use of scenario planning and diagnostic tools and models to identify and assess risk and opportunities, and proactively communicate these programs and their outputs to the Board. They should also anticipate questions from the Board and key committees, such as: Are the company's 10k risk disclosures more than just "safe harbor"? Do the risks noted in the 10k match the risks that the enterprise risk management program is focused on? What is the organization doing to prevent, detect, and mitigate risks before they occur? Is the company encouraging the development of risk management as a core competency?

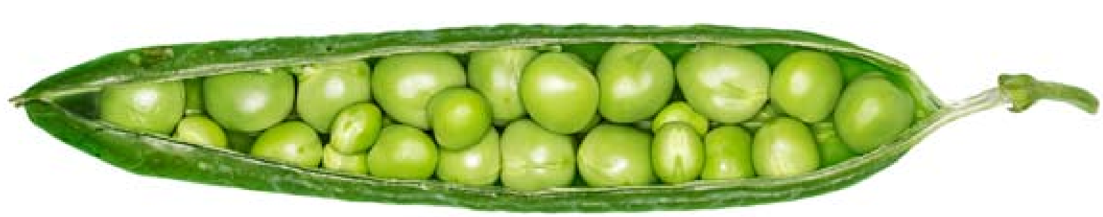
For more on the new proxy statement mandate, see "Risk Intelligent proxy disclosures: Transparency into Board-level risk oversight"

Creating a risk-diagnostic model

At a large technology and services firm, which traditionally took a piecemeal "risk of the day" approach, the Board usually delegated risk oversight to the audit committee on an as-needed basis. But the company decided to operate from a holistic view of risk and involve the audit committee in a more systematic manner.

The company set out to illustrate its view of risk more effectively and to better engage the audit committee. It also realized that for known risk areas, where the focus was on risk mitigation, the organization was performing well. But in other areas, which were not typically associated with risk, additional work was needed to help the company fill the "maturity gap" and become more Risk Intelligent.

To that end, the company customized a risk-diagnostic model that categorized its key risks along the lines of strategy, operations, reporting, compliance, and technology, as well as the means that are used to monitor and mitigate risk. The company used this tool to validate its point of view across the organization and with the audit committee and the Board, and to enable the audit committee to update how risk is monitored and managed.



How big is your risk appetite?

Some risks can't be ignored, such as maintaining regulatory compliance, producing financial reports, and complying with disclosure requirements, to name just a few. But there's no extra credit for handling these risks exceptionally well. Other risks have the potential for greater reward, and they typically call for taking bigger chances. Decision making around mergers and acquisitions is one example.

Both types of risk should be embraced and managed, because risk management is not solely about eliminating risk. It's also about understanding where risk should be taken in order to achieve objectives. Organizations, therefore, should identify areas of risk, decide where they have little appetite for risk tolerance, and determine where they might be comfortable taking a bigger bite.

Having a higher tolerance, however, is not a free pass for companies to compromise on compliance with laws, regulation, and customer value statements and objectives. Even if risks are worth taking to achieve profit goals, organizations can't cut corners or give short shrift to compliance.

Recommendation: Determine acceptable and unacceptable risks.

To make the most of both rewarded and unrewarded risks, CFOs should discuss the company's risk appetite with the Board — addressing a range of risk-appetite elements from return on capital employed to selling, general, and administrative expenses. A risk discussion should be placed on the "menu" of every meeting. But this is not to suggest that the CFO should have final say on risk appetite. That discussion should take place across and within the C-suite and Board, and decisions should be reached only after the various viewpoints have been aired. The end result should be a fundamental standard and specific guidelines, developed by management and ratified by the Board, by which all enterprise risks are judged acceptable or unacceptable.

There are "two faces of risk." Unrewarded risks (such as observing OSHA safety requirements or paying bills when they come due) can't be ignored, and the primary incentive for addressing them is value protection. Rewarded risks represent a company's strategic bets. These are the decisions a company makes to develop new products, enter new markets, or acquire new companies. The primary motivation for taking rewarded risk is to spur value creation.

New venture — good as gold?

A mining company conducted a risk-framing workshop to determine whether processing a by-product it extracted from its mines was a feasible initiative. As part of the workshop, the company generated a probabilistic risk profile and determined that the project had both a good net present value and a good internal rate of return. But given the risk exposure during the plant construction phase — with investment going out and no revenue coming in — there was a 30 percent chance that the project, as currently designed, would not break even.

Two key uncertainties in the natural resources industry are the amount of reserves the company can tap into and the commodity price. Because the waste rock already extracted had a relatively high degree of the byproduct in it, the amount of reserves was not a major concern. Rather, the driving risk was the four or five years' lag time between when the plant was being constructed and when it would start seeing revenue, coupled with the exposure to volatile commodity price fluctuations during that period. Should high-commodity prices occur during this phase, it could be difficult to recover that lost value later in the project lifecycle.

In addition to identifying risks, the risk-framing exercise enabled the mining company to identify opportunities and redesign the project to mitigate some of those risks. As a result, the company opted to buy a partial hedging contract, covering their risk exposure of not breaking even to 10 percent.

Avoiding a bad rep

Disasters, product recalls, and privacy breaches. Over the past few years, we've seen how some of the largest companies have handled — or, in some cases, mishandled — these regrettable situations. We've also seen that corporate reputation should be handled with care, what takes years to build can be toppled in an instant, and off-the-cuff statements by corporate executives can quickly elevate unfortunate events into full-scale public-relations crises.

Sometimes reputation risk is nothing you can control. Other businesses in the same industry can tarnish your image. Outsiders can sabotage your brand. Or sometimes breaches, violations, or problems from within your organization enter the public domain. There are even concerns that the recently introduced Dodd-Frank whistle-blower clause will motivate employees to air employers' dirty laundry.

Reputation can also be damaged by actions taken by parties in your extended service delivery model, such as outsourcing, manufacturing and distribution, licensing, and other vendors or partners. While these business relationships broaden a company's capabilities and reach, they also extend its risks.

As if that weren't enough, the ability of social media to instantly broadcast corporate missteps dramatically shortens the amount of time a company has to manage a blunder. With more online retailers encouraging customers to rate their purchases, too many critical reviews can discourage shoppers from buying a company's product. Blog entries and tweets, whether accurate or not, can make potentially damaging information immediately available to customers, shareholders, and the media. Even more daunting is the fact that some online entities exist for the sole purpose of shining a spotlight on secret corporate information.

Recommendation: Control your reputational risks.
CFOs need to consider what impacts their actions could have on their reputations. They should take proactive — and, if necessary, corrective — action with respect to such risks, including developing a reliable process that assesses and manages risk throughout the life of contracts and relationships. This is another area, too, where the Board should be involved; a Board that is prepared to deal with a crisis situation is less likely to delay decision making at a time when response time is critical. Many companies have also begun to track social media in order to monitor public sentiment and deal with issues before they get out of hand.

Watch for interdependent and cascading risks

A single risk on its own might not be of great concern or consequence. But in combination, the cumulative impact of risks can be staggering. The challenge, of course, is connecting the dots of seemingly isolated incidents to view the larger picture.

Managing interdependencies calls for a deep understanding of the organization, the extended enterprise, and the marketplace. It also requires recognition of how value is created, where and how value can be destroyed, where the company's vulnerabilities lie, and which risks should be accepted or mitigated.

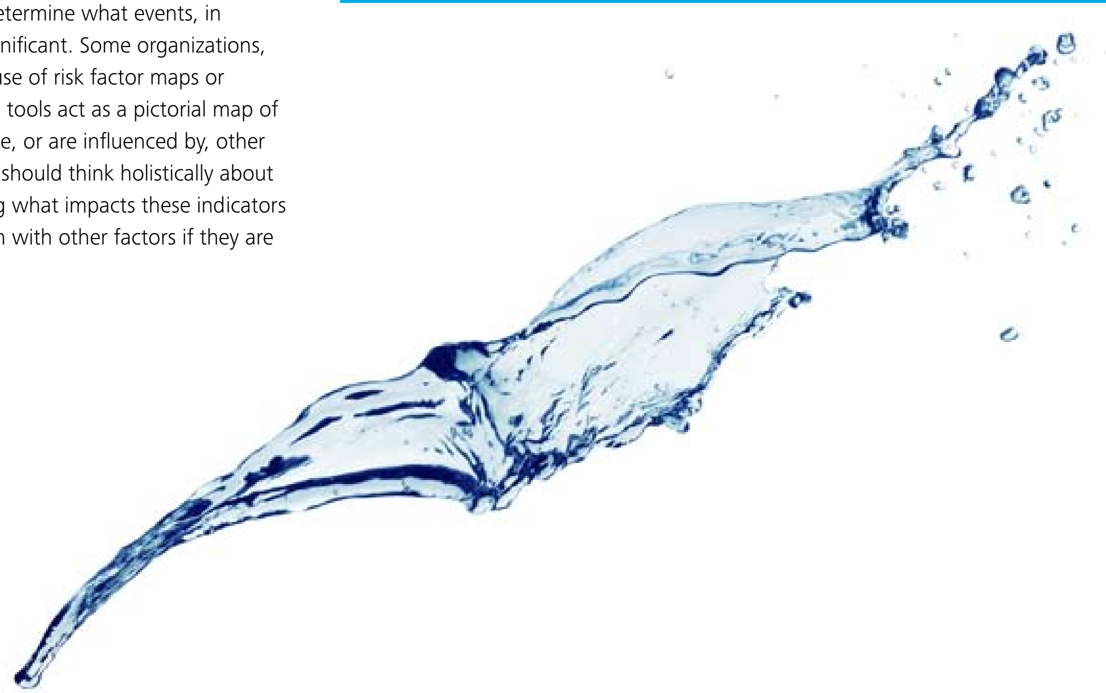
Otherwise, the failure to recognize and connect these threats can transform a trickle of small incidents into a full-scale risk event. For instance, seemingly isolated mechanical malfunctions, if underreported, might not be linked to a large-scale engineering flaw that ultimately results in product recalls.

Recommendation: Map your risk factors.
CFOs should be aware of the connections among a host of internal and external developments that could affect their organizations. They should also have a process or approach in place to determine what events, in combination, could be significant. Some organizations, for example, are making use of risk factor maps or influence diagrams. These tools act as a pictorial map of uncertainties that influence, or are influenced by, other factors. In addition, CFOs should think holistically about risk indicators, considering what impacts these indicators could have in combination with other factors if they are not addressed.

A taxing matter
The tax function is interconnected at many points to the rest of the business, and it's one of the heaviest users of financial information. But one example of interdependent and cascading risks — which is frequently seen when organizations implement ERP or other IT systems — is that the tax function is overlooked as a strategic partner, and it is consequently left out when those systems are designed.

The result: Information systems are implemented without sufficient tax functionality, and tax professionals are forced to rely on spreadsheets, pivot tables, homegrown data warehouses, and other outdated tools. Because the tax function no longer has access to the right level of detail, it must manually rework and manipulate data to perform compliance, financial reporting, and other processes. Devoting this level of attention to rework leaves little time for adding value to the business, particularly with respect to tax benefits related to or enabled by ERP implementations that can sometimes offset a significant amount of a project's costs. What's more, tax's inability to tap into current data is a root cause for many material weaknesses and deficiencies that occur.

Such interdependent and cascading risk drives the demand for scoping tax requirements into IT systems, and for remediation efforts after the fact that separately implement provision or compliance systems. But remediation efforts can be avoided when the CFO and the tax executive make sure tax is at the table for every strategic business endeavor.



Compliance and enforcement go global

Multi-jurisdictional global operations, regulations, and laws are growing in volume and complexity. The G-20 and other multilateral organizations are advancing greater cross-border cooperation and information sharing with respect to compliance and enforcement (such as through bilateral Tax Information Exchange Agreements). And the U.S. Department of Justice and regulatory authorities around the world are making anticorruption a top priority. With this heightened level of scrutiny, all companies — and multinationals, in particular — should enhance and test their compliance policies and processes. With Foreign Corrupt Practices Act penalties in the nine figures, it's imperative that this issue be top of mind for CFOs.

What's more, to have a truly world-class risk function calls for a coordinated effort among many parties — from compliance and finance to legal and operations. Without an effective way to manage and communicate across these areas, and without a CFO who can bridge those silos, a robust internal compliance initiative is difficult to achieve or sustain. A risk management committee, which would meet regularly to discuss risks across the enterprise, would also help formalize risk compliance issues and processes.

Recommendation: Create a compliance stress test.
To compete in this enhanced compliance and enforcement environment, CFOs should augment their companies' existing compliance efforts. Banks in Europe and the United States conduct capital "stress tests"; now is the time for companies to conduct *compliance* stress tests that cover key areas of reputational risk, major areas of compliance, and the effectiveness and maturity of the compliance and risk-management process.

Risks and growth opportunities go hand in hand when companies expand into foreign markets. CFOs should understand and assess geopolitical, country, and corruption risks that exist in emerging markets and develop an effective plan for managing those risks. Failing to do so can prove to be a costly lesson for companies doing business abroad.

Convert risk into opportunity

These issues have been addressed in greater detail in the previous pages, but here are a few points CFOs should keep in mind as they strive to create a Risk Intelligent organization:

1. **Prepare for the known and the unknown.** Monitor the environment to identify risks and opportunities and establish a plan for how to respond.
2. **Mind your "of"s and "to"s.** Identify assumptions that might put your strategy itself at risk, as well as threats to the execution of that strategy.
3. **Make the risks that matter *matter*.** Determine which risks matter most and communicate those to your organization.
4. **Get the Board on board.** Build involvement with the Board and the audit committee directly into your processes for addressing risk.
5. **Know how much risk you're willing to bite off.** Discuss the company's risk appetite with the Board to make the most of both rewarded and unrewarded risk.
6. **Handle your reputation with care.** Consider the effect decisions and events could have on your company's reputation and actively manage them.
7. **Connect the dots.** Think holistically about interdependent risk and the cascade effect individual risks could have in combination.
8. **Compliance knows no borders.** Stay abreast of increasingly global compliance and enforcement changes and augment your companies' existing compliance efforts.

Preventing bad things from happening is no longer sufficient. That's why Risk Intelligent CFOs focus on creating value, putting strategy at the heart of risk-management initiatives, and scanning the environment for obstacles that stand in their way.

Convert risk into opportunity. Make good things happen.

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