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Introduction

Risk—let's get this straight up front—is good. The point of risk management isn't to eliminate it; that would eliminate reward. The point is to manage it—that is, to choose where to place bets, and where to avoid betting altogether.

Thomas Stewart, *Fortune*[1]

As businesses worldwide enter the twenty-first century, they face an assortment of risks almost unimaginable just 10 years ago. E-commerce has become ingrained in society with amazing speed: Companies that cannot keep up are doomed to obsolescence in record time. Technology is driving business models to be retooled in months instead of years. The traditional gatekeepers of information are being supplemented with the Internet democracy in which anyone with a PC can disseminate information widely and quickly—for good or bad.[2] Derivatives, which were originally intended to help manage risk, have themselves created whole new areas of risk.

It is probably axiomatic that well-managed businesses have successful risk management. Over time, a business that cannot manage its key risks effectively will simply disappear. A disastrous product recall could be the company's last. A derivatives debacle can decimate staid old institutions over a long weekend. But historically, risk management in even the most successful businesses has tended to be in "silos"—the insurance risk, the technology risk, the financial risk, the environmental risk, all managed independently in separate compartments. Coordination of risk management has usually been nonexistent, and the identification of new risks has been sluggish.

This study looks at a new model—enterprise-wide risk management—in which the management of risks is integrated and coordinated across the entire organization. A culture of risk awareness is created.

Farsighted companies across a wide cross section of industries are successfully implementing this effective new methodology.

An Abundance of Uncertainty

Uncertainty abounds in today's economy. Every organization is, to some extent, in the business of risk management, no matter what its products or services. It is not possible to "create a business that doesn't take risks," according to Richard Boulton and colleagues. "If you try, you will create a business that doesn't make money."[3] As a business continually changes, so do the risks. Stakeholders increasingly want companies to identify and manage their business risks. More specifically, stakeholders want management to meet their earnings goals. Risk management can help them do so. According to Susan Stalnecker, vice president and treasurer of DuPont, "Risk management is a strategic tool that can increase profitability and smooth earnings volatility."[4] Senior management must manage the ever-changing risks if they are to create, protect, and enhance shareholder value.

Two groups have recently emphasized the importance of risk management at an organization's highest levels. In October 1999, the National Association of Corporate Directors released its *Report of the Blue Ribbon Commission on Audit Committees,* which recommends that audit committees "define and use timely, focused information that is responsive to important performance measures and to the key risks they oversee."[5] The report states that the chair of the audit committee should develop an agenda that includes "a periodic review of risk by each significant business unit."

In January 2000, the Financial Executives Institute released the results of a survey on audit committee effectiveness. Respondents, who were primarily chief financial officers and corporate controllers, ranked "key areas of business and financial risk" as the most important for audit committee oversight.[6]

With the speed of change increasing for all companies in the New Economy,[7] senior management must deal with a myriad of complex risks that have substantial consequences for their organization. Here are a few of the forces creating uncertainty in the New Economy:

- Technology and the Internet
- Increased worldwide competition
- Freer trade and investment worldwide
- Complex financial instruments, notably derivatives
- Deregulation of key industries
- Changes in organizational structures resulting from downsizing, reengineering, and mergers
- Higher customer expectations for products and services
- More and larger mergers

Collectively, these forces are stimulating considerable change and creating an increasingly risky and turbulent business environment. Perhaps no force on the list is having as great an impact on business as the Internet. As the Internet comes of age, companies are rethinking their business models, core strategies, and target customer bases. "Getting wired," as it is often called, provides businesses with new opportunities, but it also creates more uncertainty and new risks.[8] In his book *The High Risk Society,* Michael Mandel states, "Economic uncertainty is the price that must be paid for growth." To be successful, businesses must seek opportunities "where the forces of uncertainty and growth are the strongest."[9]

The mismanagement of risk can carry an enormous price. In recent years, the business community has witnessed a number of risk debacles that have resulted in considerable financial loss, decreased shareholder value, damaged company reputations, the dismissal of senior management, and in some cases the destruction of the business. Consider the impact of the following events:

- Companies selling poor-quality or defective products, or unnecessary service, coupled in some cases with severely mishandling the crisis surrounding the product recall or service problem
- Environmental disasters and inadequate attention to the resulting crisis

- Rogue traders lacking oversight and inadequate controls assuming enormous risks
- Organizations trading in complex derivative instruments without understanding the risks involved
- Mergers destroying shareholder value
- Insurance salespeople churning customers' accounts
- Sexual harassment of employees
- Racial slurs by management and discrimination against employees

This increasingly risky environment, in which a debacle can have major and far-reaching consequences, requires that senior management adopt a new perspective on risk management. The new perspective should be one that not only prevents debacles but also enhances shareholder value. Indeed, the New Economy calls for a new risk management paradigm.

New Risk Management Paradigm

In thinking about a shifting paradigm for risk management, the recipe for boiling a frog is instructive. If you drop a frog into a pan of boiling water, it will jump out. But if you put the frog in a pan of cold water and gradually raise the temperature, the frog will stay in until the water boils, not realizing that its paradigm is shifting. In a similar fashion, the risk management paradigm has been shifting gradually for some organizations. Some of them may not have recognized the paradigm shift and the advantages of the new perspective on risk management.

Traditionally, most organizations have viewed risk management as a specialized and isolated activity: the management of insurance or foreign exchange risks, for instance. The new approach has its basis in keeping managers and employees at all levels sensitized to and concerned about risk management. Table 1.1 identifies three key aspects of this shift to an organization-wide perspective for risk management.

As noted in table 1.1, the risk management perspective for some organizations is shifting from a fragmented, ad hoc, narrow approach to an integrated, continuous, and broadly focused approach. The question

Table 1.1
Key Features of the New Risk Management Paradigm

Old Paradigm	New Paradigm
Fragmented—department/function manage risk independently; accounting, treasurer, internal audit primarily concerned	Integrated—risk management coordinated with senior-level oversight; everyone in the organization views risk management as part of his or her job
Ad hoc—risk management done whenever managers believe need exists to do it	Continuous—risk management process is ongoing
Narrowly focused—primarily insurable risk and financial risks	Broadly focused—all business risks and opportunities considered

Source: Economist Intelligence Unit, *Managing Business Risks,* 10. A similar analysis is presented in DeLoach, *Enterprise-Wide Risk Management,* 15–16.

is whether senior management will make the shift consciously now or make it after the water heats up and a debacle occurs.

This new perspective on risk management is sometimes referred to as integrated, strategic, business, or enterprise-wide risk management, and we use these terms interchangeably. The term "risk" includes any event or action that "will adversely affect an organization's ability to achieve its business objectives and execute its strategies successfully."[10] The scope of risk covers all risks, internal and external, that may prevent an organization from achieving its objectives. Adding the word *management* to integrated, business, or enterprise-wide risk implies a "structured and disciplined approach" that "aligns strategy, processes, people, technology and knowledge with the purpose of evaluating and managing the uncertainties the enterprise faces as it creates value."[11] Hence, the goal of an enterprise-wide risk management initiative is to create, protect, and enhance shareholder value by managing the uncertainties that could either negatively or positively influence achievement of the organization's objectives.

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Studies of Risk Management

Enterprise-wide risk management is an emerging concept that has gained in popularity over the past decade. The recognition of a more risky business operating environment and, at the same time, increased accountabilities has led several professional organizations to address control and risk assessment in major publications. In addition, several of the Big Five accounting firms have produced documents expounding the value of enterprise-wide risk management.

In 1992, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) issued *Internal Control—Integrated Framework* (ICIF).[12] This pathfinding document departed from the traditional internal accounting control model by presenting a broad control framework of five interrelated components: control environment, risk assessment, control activities, information and communication, and monitoring. According to the document, control is the responsibility of the board of directors, management, and other personnel within the organization, not just the accountants. Particularly relevant is the identification of risk assessment as a vital component of control.

The growing importance of risk management is evidenced by the following major publications issued by professional groups since ICIF was published:

- Economist Intelligence Unit (in cooperation with Arthur Andersen & Co.), *Managing Business Risks—An Integrated Approach* (1995).
- Canadian Institute of Chartered Accountants Criteria of Control Board, *Guidance for Control* (1995).
- The Conference Board of Canada (by L. Nottingham), *A Conceptual Framework for Integrated Risk Management* (1997).
- American Institute of Certified Public Accountants, *Report of the Special Committee on Assurance Services* (1997).
- Canadian Institute of Chartered Accountants Criteria of Control Board, *Learning About Risk: Choices, Connections and Competencies* (1998).

- Institute of Internal Auditors Research Foundation (by D. McNamee and G. M. Selim), *Risk Management: Changing the Internal Auditor's Paradigm* (1998).
- International Federation of Accountants Financial and Management Accounting Committee (prepared by PricewaterhouseCoopers), *Enhancing Shareholder Wealth by Better Managing Business Risk* (1999).
- Joint Australian/New Zealand Standard, *Risk Management* (1999).
- Canadian Institute of Chartered Accountants Criteria of Control Board, *Guidance for Directors—Dealing With Risk in the Boardroom* (1999).
- The Institute of Chartered Accountants in England and Wales Internal Control Working Party, *Internal Control: Guidance for Directors on the Combined Code* (1999).
- American Institute of Certified Public Accountants/Canadian Institute of Chartered Accountants Risk Advisory Services Task Force, *Managing Risk in the New Economy* (2000).

While a few of these publications include case studies analyzing companies' experiences implementing risk management, most of the studies tend to advocate a particular generalized framework for risk management. Each of the publications listed, as well as others, appears in the annotated bibliography in appendix C.

Objectives and Approach of This Study

The objectives of this study are as follows:

- To present in-depth case analysis of several companies' risk management practices
- To identify emerging patterns in risk management that could be useful to companies in developing an enterprise-wide risk management system

The research is not intended to deduce from the case studies a uniform framework for risk management. If anything, the research indicates that when it comes to risk management, one model does not fit all companies.

With these objectives in mind, we identified five companies that were at various stages of developing an enterprise-wide risk management approach. At each company, we conducted in-depth interviews on site with senior management and other key employees. An interview protocol containing a list of questions guided the interviews (see appendix A). The case studies are based on the transcribed interviews, company-provided materials, and published information.

In selecting the companies, we sought a cross section from different industries. The five firms chosen are all public companies. They represent the agriculture (United Grain Growers), chemical (DuPont), energy (Unocal), financial services (Chase Manhattan), and technology (Microsoft) industries. Table 1.2 lists the study companies and key statistics for each.

Organization of This Study

Chapter 2 discusses the lessons learned from the five case studies. Chapters devoted to each case study follow that analysis. The last chapter gives overall conclusions drawn from the research.

Table 1.2
Case-Study Companies

Study Company	Industry	Revenues[1]	Employees
Chase Manhattan Corp.[2]	Financial Services	$22,982	74,800
DuPont	Chemical	$26,918	94,000
Microsoft Corp.	Technology	$19,750	31,575
United Grain Growers Ltd.	Agriculture	C$1,832	1,600
Unocal Corp.	Energy	$6,057	7,550

[1] Most recent fiscal year in $ millions U.S. (except for United Grain Growers, which is in $ millions Canadian).

[2] J.P. Morgan Chase & Co. as of December 31, 2000

Endnotes

1. Thomas A. Stewart, "Managing Risk in the 21st Century," *Fortune* (February 7, 2000): 202.
2. This was illustrated strikingly by the case of a 15-year-old New Jersey boy who manipulated the prices of 11 stocks he owned by posting false messages on Internet bulletin boards and in chat rooms. In September 2000, the Securities and Exchange Commission charged the boy with stock fraud. He paid $285,000 to the U.S. Treasury to settle the case (Kevin Peraino, "A Shark in Kid's Clothes," *Newsweek* (October 2, 2000): 50.).
3. Richard E. S. Boulton, Barry D. Libert, and Steve M. Samek, *Cracking the Value Code—How Successful Businesses Are Creating Wealth in the New Economy* (New York: HarperBusiness, 2000): 181.
4. See the DuPont case study in chapter 4.
5. National Association of Corporate Directors, *Report of the Blue Ribbon Commission on Audit Committees* (Washington, DC: National Association of Corporate Directors, 1999): 2–3.
6. Financial Executives Institute, "Survey: Audit Committees Should Focus on Key Business Risks," FEI Press Release, January 12, 2000.
7. New Economy companies are leaders in innovations (Internet, microprocessors, etc.) and include technology, information services, media, telecommunications, and life science companies.
8. "New Challenges Arise as All Business Becomes E-Business," *Washington Post* (September 20, 2000): G1.
9. Michael Mandel, *The High Risk Society* (New York: Times Business, 1996): 9.
10. Economist Intelligence Unit, written in cooperation with Arthur Andersen & Co., *Managing Business Risks—An Integrated Approach* (New York: The Economist Intelligence Unit, 1995): 2.

11. James W. DeLoach, Jr., *Enterprise-Wide Risk Management—Strategies for Linking Risk and Opportunity* (London: Financial Times, 2000): 5.
12. The National Commission on Fraudulent Financial Reporting, known as the Treadway Commission, was created in 1985. The commission is sponsored by the American Institute of Certified Public Accountants, American Accounting Association, Financial Executives Institute, Institute of Internal Auditors, and the Institute of Management Accountants.