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LegalFocus on Healthcare and Insurance

Policies, programs, practices & opinions for the providers, administrators & insurers of healthcare services

Risk

*Crooked managers. Changing technology. Financial surprises.
Who knows what company-killers lie ahead? Here's how directors can protect themselves.*

Rob Norton

No single four-letter word is more likely to raise a board's collective blood pressure these days than risk. The recent parade of corporate scandals can be blamed in part on a lack of effective systems to recognize and manage risk—not just insurance matters but broad operational and financial hazards to the enterprise. Now risk management has risen to the top of the agenda for many directors. Often the job falls under the authority of the audit committee, but some U.S. boards, including that of MCI (formerly WorldCom), have appointed special risk management committees. The boards of several European and Canadian companies have adopted formal processes aimed at alerting directors to the extent to which the outfits are exposed to risk and how it is managed.

The risks that blew up in the faces of boards at companies such as WorldCom, Enron, and Parmalat all come under the general category of operational risk, broadly defined as the danger of loss resulting from inadequate or failed internal processes, people, or systems, or from external events. These can include:

- Unscrupulous managers.
- Business interruptions caused by terrorism, war, or natural disaster.
- Supply-chain breakdowns.
- Changing technology.
- Increased competition.

The second, more familiar category of risk is financial, including stock-market fluctuations, variations in foreign exchange rates, and interest-rate volatility. What both operational and financial risks have in common is that they can vaporize shareholder value, create legal and regulatory difficulties, and batter a company's reputation.

"It's become clear over the last several years that instead of looking at the silos within companies where risks are located, you need to have a company-wide view, where the goal is to measure and aggregate risk across the entire enterprise," says Federal Reserve Board governor Susan Schmidt Bies. "You need to be managing these risks consistently and to understand how the different risk exposures move in relation to each other." Before she joined the Fed in 2001, Bies had worked at First Tennessee National Corp. since 1979, most recently as executive vice president for risk management.

An undetected operational risk was behind last year's scandal at the giant insurance broker Marsh & McLennan, where a lawsuit exposed long-term practices of price-fixing and bid-rigging. In addition to looming fines and settlements that could reach $1 billion, Marsh & McLennan's stock price initially fell by about 50%, its

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debt rating was downgraded, its chief executive officer resigned, several other senior executives were asked to step down, and the board was overhauled. Ironically, the Marsh website trumpets the company as "the world's No. 1 risk specialist."

"It's no secret that the risks directors need to consider in serving on a board have ratcheted up considerably in the last five or 10 years," says Judith R. Haberkorn, chair of the risk management committee at MCI. "And there's no question that every board and audit committee in the world is trying to understand all the elements of risk that face their companies."

Adds Richard Steinberg, head of Steinberg Governance Advisors in Westport, Connecticut, and a former senior partner at PricewaterhouseCoopers: "Directors need to know, in their oversight capacity, that management is bringing the most critical risks to the attention of the board. The only way they can know that is if they are comfortable that management has in place processes to identify risks throughout the organization."

Regulatory agencies around the world have enacted reforms and governance regulations designed to improve risk identification and management. Many companies have appointed chief risk officers to oversee the management of risk. Increasingly, companies are moving toward formal "enterprise risk management" (ERM) systems capable of monitoring the menu of financial and operational risks across an entire enterprise. But evidence from recent surveys shows that many boards and top executives still aren't confident that their risk management systems are effective and comprehensive.

Regulations have increasingly spelled out the need for directors to formally oversee risk management. In 2003 the New York Stock Exchange amended its listing requirements, setting forth procedures that enable audit committees to take responsibility for overseeing risk exposures and risk management processes. Last fall the Committee of Sponsoring Organizations, an influential private-sector group devoted to improving financial reporting and governance, released Enterprise Risk Management—Integrated Framework, a report aimed at providing a benchmark by which companies can evaluate ERM processes.

MCI's board-level risk management committee, which is separate from the audit committee, grew out of the company's emergence from the wreckage of WorldCom and from one of the most exhaustive corporate governance overhauls in history. Former Securities and Exchange Commission chairman Richard C. Breeden, called in to perform a postmortem and make recommendations for action, produced a 150-page report entitled Restoring Trust. It contained 78 different recommendations for governance improvements. One of Breeden's criticisms of the WorldCom directors was that their involvement in risk assessment was "strikingly absent."

"There is no indication," he wrote, "that the board analyzed how the enormous debts being accumulated by the company in acquisitions would be carried and ultimately retired. . . . The board failed to understand WorldCom's risks . . . or to design

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adequate risk control policies." Following the suggestions in his report, the revamped board formed a risk management committee consisting of three independent directors, with a detailed charter setting forth its key responsibilities. The advantage of having a committee to evaluate risk that is separate from the audit committee, says Jennifer McGarey, MCI's corporate secretary, is that the risk committee can consider a broader range of hazards than the audit committee, which tends to focus on the financial side.

Governance experts think that forming a risk management committee is a good idea, especially for larger companies. "There's a logic to giving the audit committee responsibility for oversight of risk management," says Richard Steinberg of Steinberg Governance Advisors. "The audit committee is focused on internal controls, and there's typically a great deal of overlap. But my experience is that audit committees already have a lot on their plates. There's no doubt that boards are looking now more than ever at how managements are dealing with the broad range of risks, and establishing a separate risk management committee provides additional, targeted focus for doing that."

Companies in Europe and Canada seem to be further along in instituting integrated approaches to risk management than their U.S. counterparts. PricewaterhouseCoopers devoted its 2004 Global CEO Survey to risk management. The report, Managing Risk: An Assessment of CEO Preparedness, surveyed nearly 1,400 chief executives in North America and Europe and found that comprehensive risk management is still uncommon among corporations in general and U.S. companies in particular. (Financial companies, which began following bank regulatory risk guidelines in the 1990s, are exceptions.) Just under 40% of all CEOs said that risk management was a priority for them and their boards; only 30% qualified as "advanced practitioners" of enterprise risk management. A mere 20% of U.S. CEOs said they had the information they needed to manage enterprise-wide risk, and only 12% affirmed that a common terminology and set of standards existed within their companies. Just 7% of U.S. CEOs strongly agreed that ERM was fully integrated across all units of their organizations, compared with 22% for European companies.

"On a scale of 1 to 10, with 10 being perfect understanding and management of risks, American corporations on average are currently at about 3," says Larry E. Rittenberg, a professor of accounting and information systems at the University of Wisconsin's Madison School of Business. "We should be aiming for a 7 or 8.

North of the Border, Ahead of the Curve

When EnCana—a petrochemical company headquartered in Calgary, Alberta, with $12 billion (U.S.) in revenues—was formed by a merger of two oil and gas firms in 2002, the management and board structures got an overhaul to ensure that risk management practices were up-to-date. Energy companies, subject to significant uncertainties about raw materials, currency, and supply chains, have tended to be leaders in risk assessment, and Canadian outfits generally have been quick to move toward the enterprise risk management (ERM) model. "We're proud of what we do," says John D. Watson, EnCana's executive vice president and chief financial officer, "and we like to stay ahead of the curve."

At the board level, oversight of financial risks is the job of the audit committee. But "risk in the broadest sense is a full-board responsibility," Watson says, "and the board made that perfectly clear." Each quarter board members receive three risk assessment reports—on financial risk, operational risk, and reputational risk. "Together that comprises the risk management system in the broadest sense," says Watson.

At the management level, EnCana formed a risk management committee that includes a team leader for financial risk management, who reports to Watson in the finance organization, plus representatives from human resources, the legal department, and each of the operating units.

The committee structure is important, says Watson, because a particular kind of risk—financial, reputational, or operational—might seem inconsequential in one area of the company but could be significant when aggregated with similar risks across the entire corporation. An example is regulation. "Many of our businesses are regulated, and there are a lot of complex agreements," Watson notes. "Something that one group may be dealing with in their own area of responsibility may be something they can handle, but we might discover in the committee that another group has a similar issue. Then someone else may say, 'We need to report that,' and then an issue might arise about how it affects HR."

Because EnCana stock is traded on the New York Stock Exchange, the Sarbanes-Oxley Act's Section 404 (on internal controls) is costing the company "millions" and the amount of paperwork is huge. But Watson says it has been useful: "What it's served to do is heighten the level of awareness through the organization about the implications of what risk management practices are and what could happen if they don't work out."

I'd say '10,' but you need to be realistic. What has been accomplished is that there is awareness that corporations face huge risks in all parts of their business and need to manage them holistically. What is not there yet is that at many companies, risk has not yet become part of the strategic planning process or the corporate culture in the way that managements and boards approach most issues." Rittenberg was a member of the oversight group for the Committee of Sponsoring Organizations' report and is a director himself, serving on the audit and governance committees of the board of Woodward Governor Co. in Rockford, Illinois, a maker of fuel-control systems for turbine and diesel engines.

Canadian companies moved earlier to formalize their approach to risk management. A 2003 study of Canadian risk management practices found that 31% of the country's businesses had adopted ERM and 28% were considering doing so. In Europe, meanwhile, a 2004 survey of 269 companies found that 78% had a clear policy on risk management and 75% had a formal risk management process; 57% of the companies described their risk management policy as covering the widest scope of risks, and 45% said their board of directors or audit committee dealt with risk management at least once a year.

To assess operational risks, says Larry Rittenberg, "board members should ask to what extent management is monitoring changes in competitors, changes in the business environments, and changes in the supply chain—what are the key, critical items for the organization that might present a risk." Operational risks include dramatic, unforeseen events like 9/11 but may also be found in much more prosaic areas, such as supply-chain disruptions, which can be caused by anything from a supplier's bankruptcy to a breakdown of internal processes for planning and production. In 2001 Cisco Systems announced the largest inventory write-down

Capital One's Pyramid

Capital One Financial Corp., a financial-services company based in McLean, Virginia, made risk management a strategic imperative in late 2002 for two reasons. First, the company was growing hugely: Between 1995 and 2004, it went from a credit-card issuer with six million customers, $10 billion in loans, and 3,000 employees to a diversified lender with 49 million customers, $80 billion in loans, and 15,000 employees, vastly increasing organizational complexity. Second, the heightened attention focused on public companies by investors and regulators following the Enron scandal was exacerbated for credit companies by the failures of credit-card outfits like NextCard. The goal was to move to a more structured and sophisticated enterprise risk management (ERM) approach without killing off Capital One's corporate culture of entrepreneurship.

Management gave the responsibility for centralizing oversight of ERM to Laura Newman Olle, formerly senior vice president of information-technology systems development. She was named chief enterprise risk officer in May 2003, reporting directly to Capital One's vice chairman; her job description includes "monitoring, analyzing, and reporting on key corporate risk areas to include strategic, operations, legal, and compliance," as well as managing regulatory relationships. "Enterprise risk management is intricately tied to the strategy and operations of the company," says Olle. "One of the big feeders of our strategic-planning process is an assessment of risks, and the same is true for day-to-day tactical decisions."

Capital One's ERM system was designed over six months with participation by senior management, the board, and outside specialists in risk management and regulatory compliance. The system is shaped like a pyramid, with Capital One's business-unit managers at the base, monitoring and reporting on risk in their areas. The next level up is a new executive committee, which establishes risk policies and tolerances, reviews both significant exposures to risk and the ERM system itself, and synthesizes issues for the board of directors. Oversight of risk management resides with the board, which approved an amended charter for the audit committee early last year, giving it an expanded moniker—audit and risk committee—to go with the expanded responsibilities. Because of the importance of risk management, the board opted to move oversight of Capital One's finance activities out of the audit committee and into a newly created finance committee.

Implementing ERM throughout the company was an 18-month process, Olle reports, adding that "the journey goes on" through fine-tuning. The next steps include building processes for measuring the risk management capabilities and performance of the company's business units. As for the major risks she and the board are concerned with right now, Olle singles out reputational risk, a common worry among financial-service firms.

in business history—$2.2 billion—because of flaws in its system for forecasting and ordering components.

A 2003 study by Vinod R. Singhal, a professor of operations management at Georgia Institute of Technology, investigated 838 instances of supply-chain failure reported by the media between 1989 and 2001. On average, the initial news report of a supply-chain glitch was associated with a decrease in the stock price of nearly 11%. Furthermore, the study found that this steep drop in stock price often derailed or slowed the long-term growth of the company and adversely affected its credibility with investors.

"These are humongous effects," says Paul R. Kleindorfer, co-director of the Risk Management and Decision Processes Center at the Wharton School of Business. "There's a growing realization that operational risk can bring a company to its knees, and that's been reinforced by many recent events. We're seeing a real sea change, in which boards are no longer saying, 'If it's only going to happen once every five or 10 years, we're not going to worry about it.'"

Directors view the move toward more formalized, ERM-style approaches to risk management as inevitable. "What you're going to see is more structure around risk management, more committees being formed, and more documentation of risk reports," says Louise C. Forlenza, a CPA serving on the board of Innodata Isogen, a Hackensack, New Jersey, company that helps businesses manage and distribute information on the Web. "Directors need to have a solid and detailed overview. In the old days, everything was in a report. Today we're more involved in discussing risks and including risk in our discussions of strategy."

The potential benefits of implementing enterprise risk management are apparent in the results of PricewaterhouseCoopers' 2004 CEO study. Of the CEOs who said that ERM was a priority, 60% stated that they had confidence in their business operations and 50% said risk management had led to clarity in organization-wide decision-making and the chain of command. Among those not committed to ERM, only 35% said that they had confidence in their business operations and 19% that risk management had helped decision-making. Risk management processes may turn out to be an area in which more scrutiny—and more regulation—also create the conditions for better and more profitable business practices. L&G

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Calendar

IINFUSING QUALITY INTO PRACTICE - 2005 SUMMER INSTITUTE ON EVIDENCE-BASED PRACTICE
July 7-9, 2005
San Antonio, Texas
For more info: www.acestar.uthscsa.edu/institute/su05.html

THE CHANGING FACE OF DISASTER MANAGEMENT: DEFINING THE NEW NORMAL
July 10-13, 2005
Toronto, ON
For more info: www.wcdm.org

INTERNATIONAL MENTAL HEALTH PROMOTION SUMMER INSTITUTE
July 11-13, 2005
Toronto, ON
For more info: www.camh.net

NATIONAL INSTITUTE FOR MENTAL HEALTH CONFERENCE
July 18-19, 2005
Bethesda, Maryland
For more info: www.blsmeetings.net/MHSR

AIME 05 10TH CONFERENCE ON ARTIFICIAL INTELLIGENCE IN MEDICINE
July 24-27, 2005
Aberdeen, Scotland
For more info: www.csd.abdn.ac.uk/aime05

PRIMARY HEALTH CARE IN CANADA
September 15 -16, 2005
Toronto, ON
For more info: www.insightinfo.com

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OCTOBER 22-26, 2005
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October 31- November 2, 2005
Toronto, ON
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10 Questions Every Director Should Ask

A best-selling management guru offers a checklist that board members can use to keep their company focused on the real drivers of wealth.

Ram Charan

As boards take charge of how they work, they must also take charge of what they work on. One way to ensure that a board is talking about the things that really matter is to consider the 10 questions every director should ask. The purpose of the questions—to which directors should, but often don't, know the answers—is to help them discover for themselves the areas on which the board might wish to spend more time. Each of the questions here opens the door to a set of follow-ups that determine the extent of the individual's knowledge—and that of the board—on particular issues.

Do you have the right CEO?

The single most important thing you can do as a director is be at peace with yourself on this question. Further, if you are comfortable that this is the right CEO, how are you going to help this valuable officer get better? If you are not comfortable with the CEO, what are the board's plans to do something about it?

Beyond the current CEO, a director must also be comfortable with the succession process. Does the board own it? How disciplined is it, in the case of either an emergency or a planned retirement? How well do you know internal candidates? If you're not satisfied with the internal candidates, what is your plan to recruit from the outside? How rigorous is your selection process? These are the questions that should keep directors up at night.

How well is the CEO's compensation linked to actual performance?

The CEO's compensation is a critical link between the board's philosophy for the company and the actions the CEO will take. Because the CEO's job is so multifaceted, the board can't sit back and simply say,

"We pay the CEO to boost the stock price." Directors must be clear on how compensation reflects both the board's goals and the company's actual performance. Are the performance measurements clear? Will the compensation plan encourage the right behavior?

Of course, the final compensation number is the one that will ultimately appear in the headlines. With that in mind, have you done the math to see how much all the components of compensation could add up to? If the CEO retires early, what's the total value? With regard to equity compensation, have you considered scenarios of sharp market movements? The compensation plan must remain fundamentally relevant under these circumstances. If the stock price rises dramatically, for instance, how much does the CEO stand to make? What if it falls?

Do you have a precise understanding of the moneymaking recipe in the chosen strategy?

No two companies have exactly the same recipe for making money, not even competitors in the same segments. Some may appear to be similar, but in fact every business, whether a corner grocer or a Fortune 500 company, has a unique approach. Directors have to understand a company's strategy and how it translates into a moneymaking recipe. Understanding how a company, a division, or a major product category makes money is crucial. What makes it distinct from competitors, and how long will the competitive advantage last? Will investors appreciate the strategy?

Do fellow directors have the same understanding of the strategy, the plan to make money? As the answers to these questions emerge, they will reveal the key assumptions on which the moneymaking strategy hinges—garnering more shelf space at Wal-Mart, for example, or improving the returns on R&D investments. Relevant activities can then be incorporated into CEO evaluation, compensation, and performance monitoring.

Is the management team looking at external trends and diagnosing the opportunities and threats presented?

The prosperity and survival of the corporation is dependent on adjusting to changes in the external environment. These changes come from a variety of sources: competition within the industry, new entrants, technology changes, new distribution channels, regulation and legislation, activists, global economic trends, and so on. A company's strategy makes sense only within this current and future context. So a board must be satisfied that management has properly assessed external trends, has a plan to address both emerging opportunities and looming threats, and continues to be exceptionally alert to changes. Are rival firms getting in or out of one of your key businesses? Is the competitive dynamic within the industry changing? Are there drivers of change in market segmentation? How well are you, as a director, contributing to the detection of these patterns?

What are the sources of organic growth?

All public companies have to grow. Though acquisitions play a role, companies with longevity have always used organic growth to create long-term shareholder value. Is the CEO's growth plan grounded in reality, or wishful thinking? Has management gone over the plan with the board and kept the board up-to-date on progress? Is organic growth factored into the compensation package of the CEO and other leaders? Is it good growth—that is, growth that is sustainable, profitable, and capital-efficient?

In some businesses and industries, growth emerges from extensive investment in long-term capital projects. Think pharmaceuticals or semiconductors. Are you periodically informed as to how those projects are progressing, which ones still show promise, which ones are fizzling out, and how much capital is being invested in the projects? In other businesses and industries, growth might depend on the latest wave of product introductions or on geographic expansion. Are you monitoring the markets on which the company's growth is predicated?

How rigorous is the process for developing the leadership gene pool?

A critical success factor for the long term is the quality of the company's human resources. The success of the company is directly linked to the right leadership and skill mix at all levels of the corporation. With a superior leadership gene pool, a company will survive short-term bumps in the road and come out ahead in the long term. How comfortable are you with the set of filters through which leaders are selected, promoted, and developed? How often does the board review it? Has management identified trends that will affect the company's future needs? How is management refreshing the leadership gene pool against those needs at all levels? Is the desire to maximize short-term financial success suppressing the continuous development of leadership? What major investments or initiatives are being made?

Do you have the right approach to diagnosing financial health?

When the savviest directors (and investors too, for that matter)—people like Warren Buffett—assess a company, they look at cash flow first, not net income or earnings. Tracking cash is the best way to see how the various parts of the business work together. The idea is to use cash flow to quickly reveal which business units are performing and which aren't, and to detect changes in the pattern. Where is cash coming from? Where is cash going? How do the inflows and outflows work together to create value?

Just as important, directors must be comfortable that the company will survive should adverse circumstances arise. Boards need to keep an eye on the company's long-term obligations, including its pension funding and off-balance-sheet financing. Let a debt burden get too big and a major problem looms if business doesn't work out according to plan. High debt reduces management's margin for error; it can hamstring efforts to grow and can magnify risks.

Are you examining measures that capture the root causes of performance?

For most businesses, accounting figures—revenue recognition, costs, inventories, and the like—are a historical aggregation of estimates. They provide little insight into how the business is executing today. Progressive boards identify the physical drivers whose permance measure you see? How do the measures compare with the competition, and how are they affected by macro factors such as changes in the economy?

Do you get bad news from management, in time and unvarnished?

Even the best of companies will stumble on occasion. Whether a key microprocessor is producing a calculation error or a flagship product is tainted in one country, the board needs to hear the bad news—promptly. Is management sharing bad news with the board? If not, why not? If bad news is shared, is management's plan to address it credible? In some cases, board members have provided sage guidance for management—to settle a lawsuit rather than fight it, for example. That can happen only if management shares the bad news.

How productive are executive sessions?

Executive sessions are a critical vehicle for directors to air their feelings, test their hypotheses, and reach a group viewpoint on items that really matter. The board can make a CEO more productive—or it can dilute the power of the CEO. Is the board coming to a consensus viewpoint on the handful of most important issues? How accurate and precise is the feedback given to the CEO? How constructive and useful is the feedback? What has been the CEO's response and follow-through?

In pondering the 10 questions, a director who is not completely comfortable with the answers should bring up anything that troubles him in executive session. The board might want to raise the importance of a given issue on the agenda and increase the depth of dialogue on the topic.

Once these 10 questions have been answered, and the answers have been discussed within the board, they should be directed to management as well. The process of interacting with management over the answers can be illuminating. Discussion on these issues isn't done merely to hear management's answers. Directors should unmask the assumptions behind the answers, and listen to how those answers are delivered. The process need not—and should not—feel like an interrogation; the gotcha approach is unproductive. What is needed is a conversation—an unscripted exchange conducted in plain language.

If that engagement feels stilted, if questions are dismissed or glossed over with platitudes, or if management responds with slick charts and graphs that skirt the tough issues, a director must press on to really understand how the company is performing.

The fact that directors are raising these questions signals to management what the board believes is important. Just asking them is a good way to get the company's top managers focused on the right issues—even if they don't have the right answers just yet. L&G

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