RISK INTELLIGENCE AND THE CFO

Boards are asking hard questions about risk and are seeking better processes to manage uncertainty in a challenging economic and regulatory environment. Increasingly they turn to the CFO who is seen as a voice of risk-related thinking and, often, the de facto chief risk officer. **Gerry Fitzpatrick** discusses how the CFO can become more risk intelligent to not only prevent bad things from happening but also to assist the organisation in taking the right risks.

For the last number of years, Deloitte has been gauging sentiment among Irish CFOs on a whole host of issues relating to the business environment. One of the areas that we investigate relates to the risks that CFOs have to deal with on a daily basis. It is clear there are a myriad of such risks. To cite some examples, CFOs are increasingly preoccupied with issues such as exchange rate risk. Some 41% of CFOs identified this as the highest risk to their companies. Market risk remains a key worry and the number of CFOs who identified this as a concern reached an all-time high in the second quarter of this year.

So how do CFOs go about embedding risk intelligence in their organisations? Set out below are some tips that may help you become increasingly risk intelligent and navigate the tricky conditions which are now the norm in today's marketplace.

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 organisation might already be thinking about. 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. Developments and activities within the organisation can also blind-side a company.

Recommendation: Create comprehensive scenario plans

CFOs should be vigilant in monitoring the environment for new risks and opportunities. They should develop a process to assess relevant, high-impact events, determine how quickly an event could happen and how swiftly they would need to respond. Establish an 'incident command system' to facilitate communication, preparation, and response. Keep communication channels open. Make sure bad news gets escalated.

ARE YOU A RISK INTELLIGENT STRATEGIST?

Boards and executives put significant effort into developing a strategic plan. But how robust is your process for recognising and responding to threats that stand in the way of strategy execution? Obtaining financing for a new venture is an example of a threat 'to' the strategy. Leaders, however, often have a blind spot about 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. If the assumptions that underlie the strategy are no longer valid, the processes that were built on those assumptions may become ineffective or damaging.

Recommendation: Recognise 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 is vital that others in the C-suite understand that value and risk are inseparable and that opportunity is the other side of risk. As for risks 'of' the strategy, make a practice of identifying any assumptions that could disrupt your strategy. 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.

THE 'VITAL FEW' AND THE 'TRIVIAL MANY'

You can't prepare for everything. So the question becomes how to determine – and act upon – what is practical and prudent. It is not simply a case of identifying risks: it is about categorising risks, aggregating risks, sorting the 'vital few' from the 'trivial many', and making those vital risks matter. To help focus on key threats and opportunities, four major risk categories – strategic, operational, financial, and compliance – can be viewed

from a stakeholder's perspective. A number of organisations are also exploring the use of predictive analytics to help determine which questions and risks matter most, and to focus on the critical issues that need to be acted upon.

Recommendation: Put signals in place and define thresholds

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

IS THE BOARD ON BOARD?

Good governance requirements highlight 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 to identify, manage, and address risk under uncertain economic conditions.

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 programmes and their outputs to the Board.

RISK APPETITE

Some risks can't be ignored, such as maintaining regulatory compliance, producing financial reports, and complying with disclosure requirements. But there is often no extra credit for handling these risks exceptionally well. Other risks have the potential for greater reward and often 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 is also about understanding where risk should be taken in order to achieve objectives.

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' for every meeting.

AVOIDING A BAD REPUTATION

We all know 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 not something you can control. But 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 mistakes dramatically shortens the amount of time a company has to manage a blunder.

Recommendation: Control your reputational risks

CFOs need to consider what impact 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 where the Board should be involved; a Board that is prepared to deal with a crisis situation is less likely to delay decision-making when response time is critical. Many companies have also begun to track social media to monitor public sentiment and deal with issues before they get out of hand.

INTERDEPENDENT AND CASCADING RISKS

A single risk on its own might not be of great concern or consequence but the

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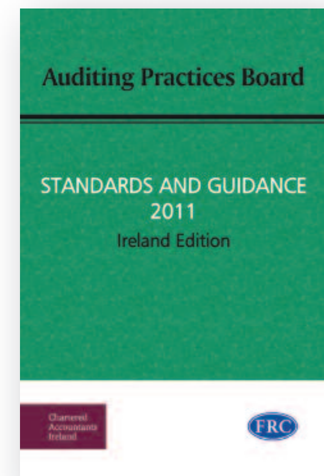

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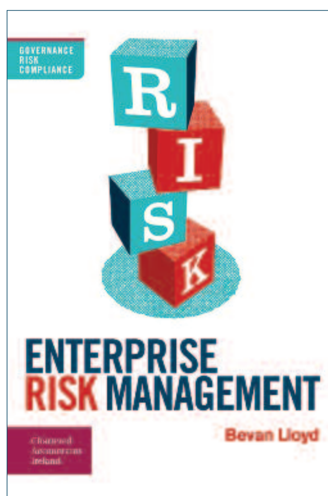
As a direct result of the current economic crisis, the areas of corporate governance in general and enterprise risk management in particular have been receiving increased attention from their various stakeholders. Senior management, non-executive directors, internal auditors and even shareholders have been required to review, re-assess, and frequently re-design existing practices and procedures in their organisations with a view to avoiding a repeat of past mistakes.



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> “IF THE ASSUMPTIONS THAT UNDERLIE THE STRATEGY ARE NO LONGER VALID, THE PROCESSES THAT WERE BUILT ON THOSE ASSUMPTIONS MAY BECOME INEFFECTIVE OR EVEN DAMAGING.”

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 organisation, 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. Failure to recognise and connect threats can transform a trickle of small incidents into a full-scale risk event.

Recommendation: Map your risk factors

CFOs should be aware of the connections between a host of internal and external developments that could affect their organisations. They should also have a process or approach in place to determine what events, in combination, could be significant. Some organisations, for example, are making use of risk factor maps or influence diagrams. These tools provide 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.

COMPLIANCE AND ENFORCEMENT

Multi-jurisdictional global operations, regulations, and laws are growing in volume and complexity. With this heightened level of scrutiny, all companies should enhance and test their compliance policies and processes. To have a truly world-class risk function calls for a coordinated effort among many parties – from compliance and finance to legal, tax 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, that meets regularly to discuss risks across the enterprise, would help formalise 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. 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.

As a progressive CFO you should be anticipating the hard questions the Board may have about risk. Make sure that when they turn to the CFO that they can see a Risk Intelligent CFO. That requires a practical approach that factors the consideration of risk into every strategy, decision, and activity, enabling the company to take advantage of the opportunities risks can create. ■

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