

Good risk. Bad risk.

Are you taking intelligent risks to drive value?

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Risk is a fundamental part of business. But that doesn't mean all risks are the same. Companies that focus on the wrong risks are wasting their time and money—and ultimately, short-changing their shareholders.

The shares of a major manufacturer plunged by more than 25 percent after the company issued its fourth profit warning in five quarters. Traditionally a market leader, the company was slow in responding to the strategic risk from competitors aggressively introducing products with new features. Efforts to reduce costs through a massive reorganization also left the company vulnerable to operational risk. The company had consolidated more than 30 administrative centers into just three, which slowed order fulfillment and billing, while simultaneously increasing customer administration costs and accounts receivable. By year's end, the company had lost more than half its market value. However, if the company had taken a more systematic approach to managing risk, it might have avoided this unfortunate fate.

A Risk Intelligent Enterprise™ understands the value of actively managing all forms of risk, and tailors its risk management practices to fit the business' unique needs and circumstances.¹ In our experience, companies that follow this intelligent and comprehensive approach to risk consistently outperform those that don't.

Rewarded versus unrewarded risk

Some risks are all downside and no upside. For example, failure to comply with Sarbanes-Oxley can have significant consequences, but there's no extra credit for being exceptionally compliant. Similarly, it's important to avoid disruptions to critical operations and systems, but doing so doesn't earn a premium from investors—it simply meets their expectations. We call these types of risks unrewarded risks. They can't be ignored, but the primary incentive for tackling them is value protection.

Other risks are all about upside—for example, introducing new innovations or expanding into new markets. The primary impetus for taking these rewarded risks is value creation. Although they might have a very significant downside, the potential upside is even greater.

This distinction between rewarded and unrewarded risks seems simple, but it's amazing how often companies fail to recognize the difference. In some cases, they focus the bulk of their attention on the threats and wind up missing out on the opportunities. In other cases, they do whatever they can to avoid significant risks—regardless of the potential benefits. Either way, the result is chronic underinvestment in the kinds of opportunities that drive growth and create value for shareholders. Risk intelligent companies, on the other hand, understand the distinction between rewarded and unrewarded risks—and respond accordingly.

Risk on the rise

A recent study of S&P 500 stocks showed that overall risk levels more than doubled between 1985 and 2006.¹ In 1985, only 35 percent of the S&P 500 faced high risk and highly volatile long-term earnings growth. By 2006, that number had risen to 71 percent. During the same period, the number of companies enjoying low risk and volatility fell from 41 percent to 13 percent.

Risk and uncertainty are being fueled by three major factors. The first factor is speed. In today's business environment, things change very quickly and companies that don't respond in time can easily find themselves on the outside looking in. The second factor is uncertainty. With so many changes occurring at once, it's difficult to know how things will shake out. What will tomorrow's customers want? What will competitors do? What unforeseen disasters, economic events, or legislative requirements will dominate the business environment? No one really knows. The third factor is connectedness. In a global, connected economy, changes or trends that occur in one industry or region have a nearly instantaneous impact on everyone else. In this highly volatile environment, no company is safe.

¹ Colvin, Geoffrey, "Managing in Chaos," *Fortune*, October 2, 2006.

To better appreciate the many risks that today's companies face, consider this example. One of our clients is a large, publicly traded technology company. Market analysts and investors expect the company to deliver steady and consistent revenue growth of roughly 12 percent, year after year; however, with technology prices constantly falling, that annual revenue target actually corresponds to volume growth of at least 20 percent. To protect its existing value, the company must address unrewarded risks, such as poor customer service, supply chain disruptions, shortages of critical talent, and regulatory non-compliance. Failure to do so is likely to disappoint the market and erode the company's share price. However, to actually create shareholder value, the company must go even further by delivering innovation and growth that exceeds expectations. That means continually tapping new markets, developing new products and services, and establishing new business models and alliances.

Common pitfalls in assessing and managing risk

Whether the emphasis is on value creation or value protection, there are a number of common mistakes that companies make in evaluating and managing risk.

Value creation pitfalls:

- Top executives aren't truly convinced that employees enterprise-wide need to know and understand the company's business strategy, value objectives, and associated risks.
- No common language has been established to help employees and managers use the concept of value to guide their decisions and actions.
- Processes, systems, and people are somehow expected to magically align with the company's business strategy.
- An enterprise view of the company's project portfolio does not exist -- and top executives aren't convinced one is needed— even though such a portfolio often represents most or all of a company's discretionary financial and resource investments
- Over-commitment to a particular strategy and course of action makes the company inflexible, increasing the risk of failure.
- Lack of an integrated performance management program with key performance indicators makes it difficult to react quickly when performance starts to lag.
- Not enough accountability for achieving results. Appropriate and calculated risk-taking is unrewarded, and compensation and rewards are not explicitly linked to performance.
- The company does not evaluate and plan for all risk factors when evaluating new business ventures.
- Shared risks and dependencies between various objectives are not understood.

Value protection pitfalls:

- The company lacks a systematic approach to understand how the business could fail and doesn't take steps to prevent such failure—for example, by challenging fundamental business assumptions to reveal underlying changes.
- Because most of the company's traditional risks are being handled by specialists, executives aren't convinced of the need for a more comprehensive and systematic approach to manage risk across the silos.
- Although many risks have been identified, they have not been prioritized through an explicit link to shareholder value.
- Risk identification and assessment are sporadic, once-a-year activities for certain functions, rather than an ongoing enterprise-wide effort. Risk management focuses on ice cubes, while overlooking icebergs.
- Risk management is seen as separate and distinct from managing the business, and is not embedded in the company's day-to-day processes.

- Risk management has evolved through silos, leading to differences in terminology, measurement, and reporting that can undermine efficiency and effectiveness.
- Executives and board members find it almost impossible to get a “portfolio” view of the risks that affect the company.
- Decision-makers have a false sense of confidence because they “don't know what they don't know.”
- Use of probabilities for risks that rarely occur can lead to inappropriate assumptions about the company's true risk exposure.

Using risk to create value

In these increasingly risky times, managing risk has never been more difficult—or more important. Here are some key principles for managing risk more effectively:

- Distinguish between rewarded and unrewarded risks. People at every level of the company must understand the various types of risk—and act accordingly.
- Balance your time and resources between rewarded and unrewarded risks. The key to growth and value creation is effectively identifying and managing rewarded risks, while at the same time protecting your existing assets
- Become more efficient at protecting value. Reduce the costs of protecting your company's assets. Harmonize, synchronize, and rationalize your existing risk management functions. Where it makes sense, drive down the cost and burden of compliance by developing common approaches to risk management enterprise-wide.
- Turn unrewarded risks into rewarded risks. It's sometimes possible to convert an unrewarded risk into a rewarded risk. For example, some companies are using Sarbanes-Oxley compliance as a springboard for improvement and business transformation, instead of just settling for compliance.

Driving more value by becoming “Risk Intelligent”

Companies often treat risk and value as separate silos. On the risk side, they may invest significant time and effort into protecting themselves from threats, but don't actively look for ways to convert those threats into opportunities. Similarly, on the value side, they might make bold investments in new market opportunities, while not doing enough to actively manage the risks that could prevent those opportunities from paying off.

In reality, risk and value are two sides of the same coin – and should be managed as such. The key to being risk intelligent is finding the right balance to both protect and create value. In most cases, that means increasing your emphasis on rewarded risks and actively managing those risks to deliver the expected returns. It also means scrutinizing your investments in unrewarded risks to be sure they are effective and efficient. Remember, the market doesn't give extra credit for protecting your existing assets. That's just table stakes.

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