Director Notes

Risk in the Boardroom

by Matteo Tonello

Any business is exposed to risks that can threaten its ability to execute its strategy. For this reason, strategy and risk oversight are inherently connected. Today, more than ever, the board of directors is expected to thoroughly assess key business risks and ensure that the enterprise is equipped to mitigate them. This *Director Notes* discusses the current corporate practices on risk oversight by directors of U.S. public companies.

Findings detail where the board assigns these responsibilities, whether it avails itself of dedicated reporting lines from senior management on risk issues, and the degree to which it adopts a standardized framework on enterprise risk management (ERM). Given the correlation between risk and strategy, data on the frequency and forms of strategic reviews is also presented. The findings are from the most recent edition of the Board Practices Survey, which The Conference Board conducts annually in collaboration with NASDAQ OMX and NYSE Euronext (see "The Board Practices Survey" on p. 5).

The Dodd-Frank Act mandates that financial institutions strengthen their risk oversight by establishing a dedicated risk committee of the board of directors.[1] In addition, U.S. Securities and Exchange Commission (SEC) rules require all public companies to disclose the extent of their board's role in overseeing the organization's risk exposure, including how the board administers its risk oversight function and how the leadership structure accommodates such a role.[2] Finally, in October 2009, the SEC reversed a policy under which shareholder proposals relating to the evaluation of risk could be excluded from a company's proxy materials as related to the company's ordinary day-to-day business activities.[3] Collectively, these developments are a nod in the direction of addressing the risk oversight failures that played so prominently in the 2008 financial crisis. Most important, they are expected to increase scrutiny of risk management programs and their endorsement and close supervision by senior leaders of corporations.

1 Section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

2 Item 407(h) of Regulation S-K, as amended, under the Securities Act of 1933.

3 Shareholder Proposals, SEC Staff Legal Bulletin No. 14E (CF), October 29, 2009, available at www.sec.gov.

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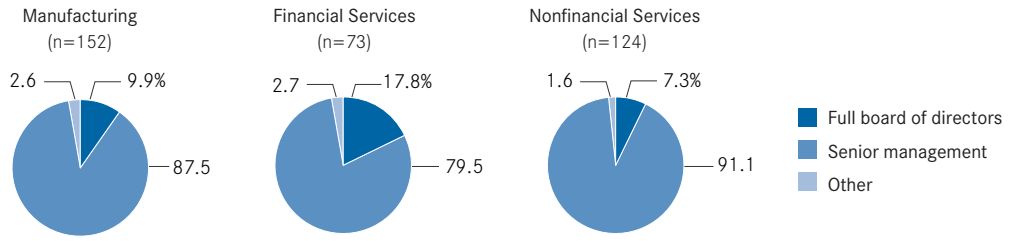
Responsibility for Strategy Setting

In the last decade, corporate directors have been paying a great deal of attention to issues of governance and regulatory compliance, therefore expanding their monitoring role. However, corporate strategy remains the most critical agenda item for a board. Directors advise senior executives on strategic planning by offering their expertise, analytical skills, and insight. Moreover, the board oversees the progress made by management in pursuit of the company's strategic objectives, even in light of a rapidly changing business environment.

Figures 1 and 2 illustrate data on the responsibility for strategy setting. Across industries and size groups, senior management is primarily responsible for setting strategic objectives, while the full board tends to be more involved in the process if the company is smaller (for example, in 16.7 percent of companies with annual revenue of less than $100 million, compared to 3.2 percent of those with annual revenue of $20 billion or greater).

Figure 1

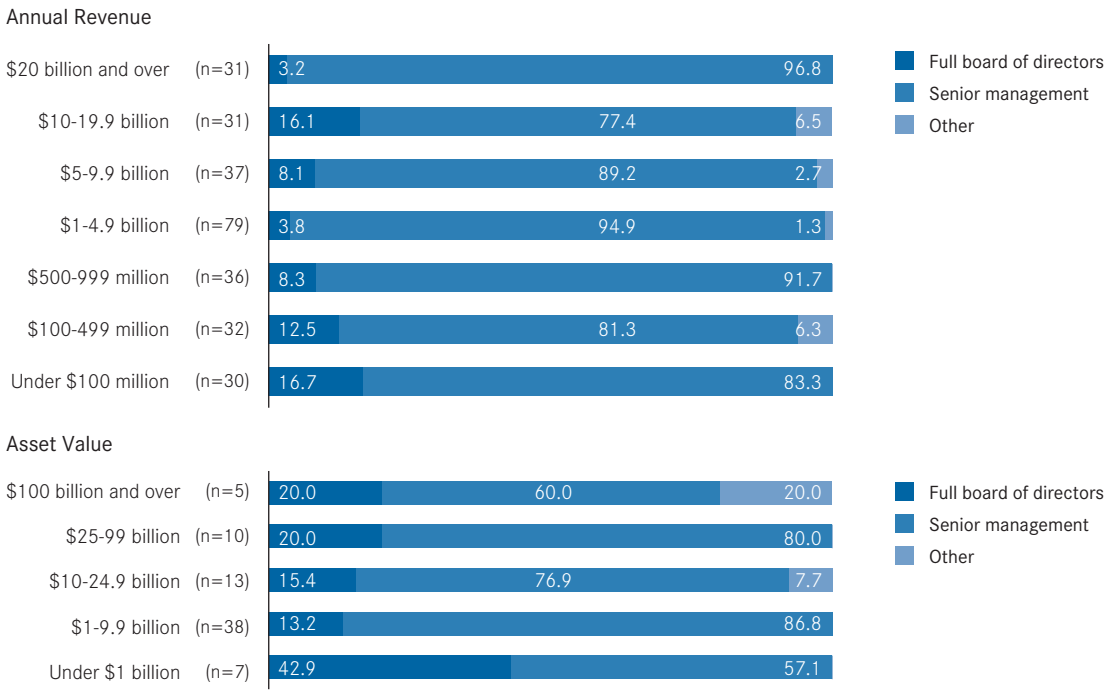
Responsibility for Strategy Setting, by Industry



Source: The Conference Board/NASDAQ OMX/NYSE Euronext, 2013.

Figure 2

Responsibility for Strategy Setting, by Company Size



Note: Total may not equal 100 percent due to rounding.
Source: The Conference Board/NASDAQ OMX/NYSE Euronext, 2013.

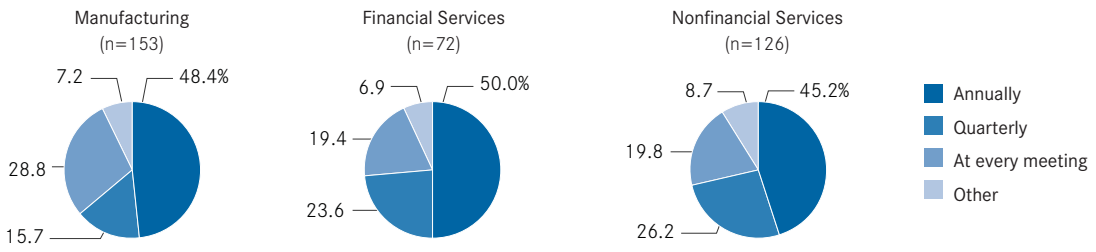
Frequency of Strategy Review

In approximately half of the companies—across industries and all but the largest (by annual revenue and asset value) of the size groups—the board reviews the business strategy on an annual basis (Figures 3 and 4).

The size-based analysis shows that strategy discussion is a regular board meeting agenda item for 38.7 percent of boards of directors at companies with annual revenue of $20 billion or greater.

Figure 3

Frequency of Strategy Review, by Industry

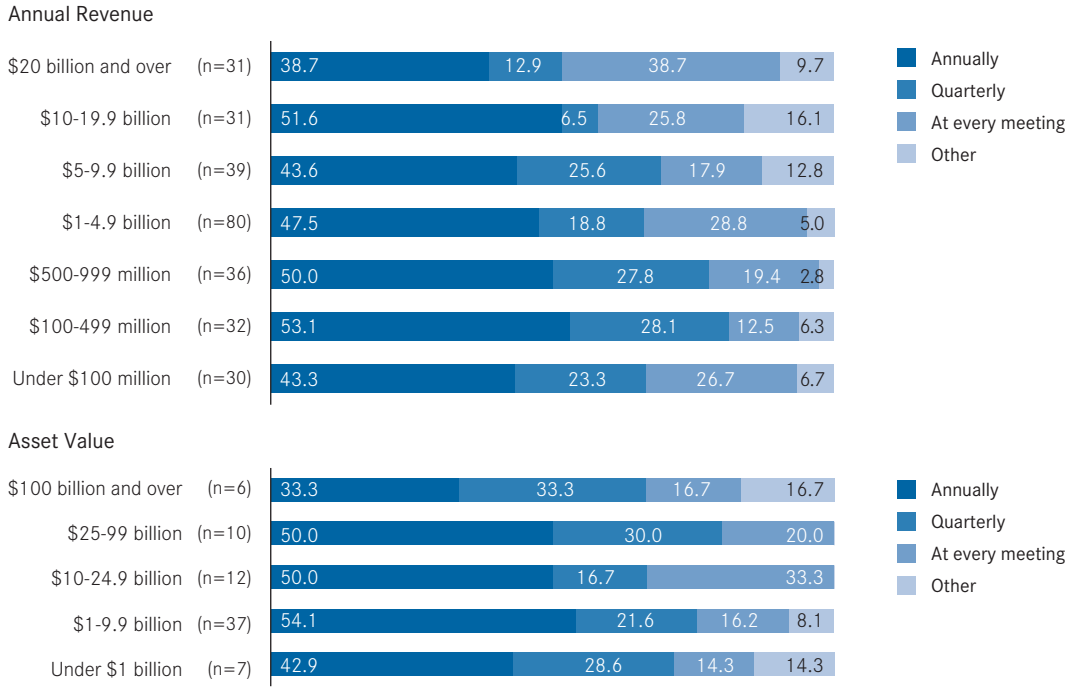


Note: Total may not equal 100 percent due to rounding.

Source: The Conference Board/NASDAQ OMX/NYSE Euronext, 2013.

Figure 4

Frequency of Strategy Review, by Company Size



Note: Total may not equal 100 percent due to rounding.

Source: The Conference Board/NASDAQ OMX/NYSE Euronext, 2013.

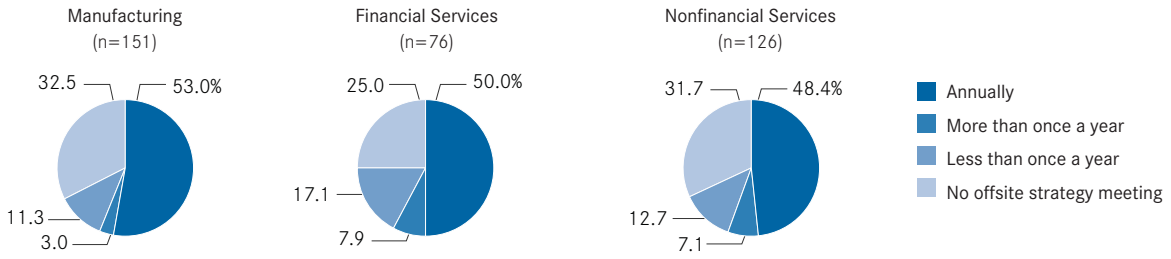
Offsite Strategy Meetings

Figures 5 and 6 illustrate the frequency of offsite strategy meetings of the board. The majority of companies, across industries and most size groups, hold offsite board meetings dedicated exclusively to strategy discussion.

While 71.4 percent of large financial services companies with asset value of $100 billion or greater hold such meetings once a year, 57.1 percent of their counterparts with asset value of less than $1 billion do not organize an offsite strategy meeting for directors.

Figure 5

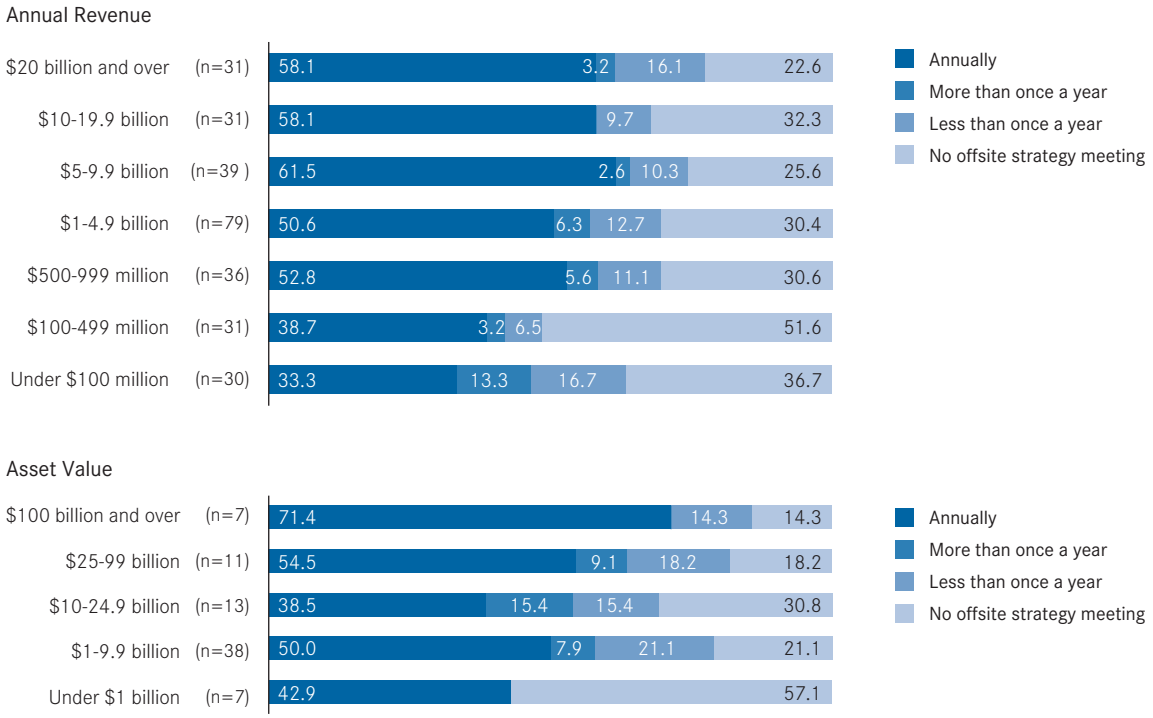
Offsite Strategy Meetings, by Industry



Source: The Conference Board/NASDAQ OMX/NYSE Euronext, 2013.

Figure 6

Offsite Strategy Meetings, by Company Size



Source: The Conference Board/NASDAQ OMX/NYSE Euronext, 2013.

ERM Framework Adoption

The integration of risk management procedures across the company has undergone a significant standardization effort. In the United States, in particular, this effort was driven by the ERM guidelines issued in 2004 by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). More recently, other options have become available: in 2009, for example, the International Organization for Standardization (ISO) completed and published *ISO 31000, Risk Management—Principles and Guidelines*.

Companies in the financial services industries were initially the most receptive to the newly introduced ERM standards. Since then, manufacturing and nonfinancial services companies have made significant progress.

As shown in Figure 7, slightly less than three-quarters of companies across industries reported that their risk management procedures are based on a widely accepted ERM framework.

Moreover, the popularity of ERM increases among the largest organizations (Figure 8). In the financial sector, for example, 85.7 percent of the largest companies (i.e., with asset value of $100 billion or greater) have adopted some form of ERM. The smallest companies (as measured both by annual revenue and asset value) were the only ones with less than a majority of ERM framework adopters.

Figure 7

ERM Framework Adoption, by Industry

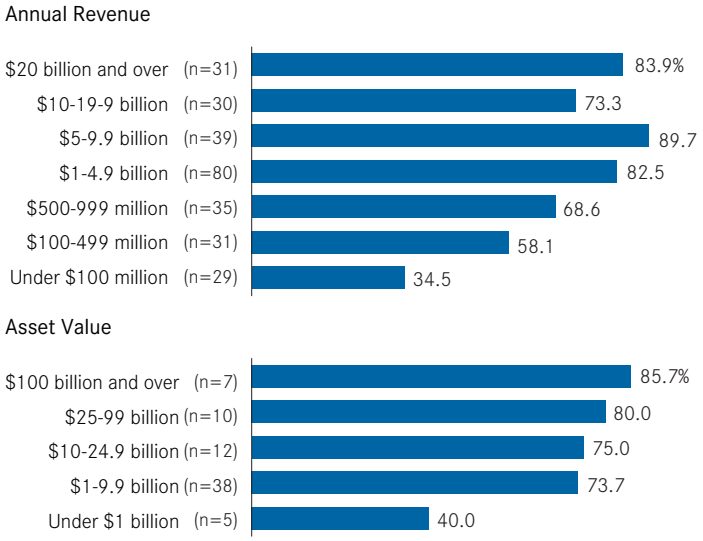
Companies adopting an ERM framework

Source: The Conference Board/NASDAQ OMX/NYSE Euronext, 2013.

Figure 8

ERM Framework Adoption, by Company Size

Companies adopting an ERM framework



Source: The Conference Board/NASDAQ OMX/NYSE Euronext, 2013.

The Board Practices Survey

Data discussed in this report is based on a survey of 359 SEC-registered business corporations administered by The Conference Board in collaboration with NASDAQ OMX and NYSE Euronext from March through June 2012. Participants were asked to provide information based on corporate practices existing at the time of the survey or, in some cases, based on disclosure provided to shareholders in proxy statements and other SEC filings regarding FY2011.

Survey findings are categorized and analyzed according to the 22 industry groups (using their Standard Industrial Classification [SIC] codes) and the size of participating companies. The size breakdowns include seven annual revenue groups (based on data received from manufacturing and nonfinancial services companies) and five asset value groups (based on data reported by financial companies, which tend to use this type of benchmarking).

For a more detailed discussion of survey findings, which extend to other areas of corporate governance and board practice, see *Director Compensation and Board Practices: 2013 Edition*, The Conference Board, Research Report 1509, 2013.

Responsibility for Risk Oversight

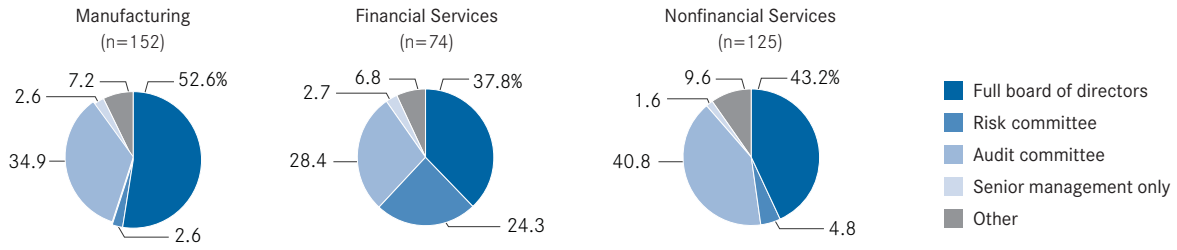
The COSO guidelines recommend that organizations leave behind a culture of risk management that focuses exclusively on financial risk and assigns its oversight responsibilities to the audit committee only. Under ERM, risk management is an enterprise-wide series of coordinated activities that aim at elevating to the senior executive and board level any material risk that could affect the company's ability to achieve its strategic objectives.

In addition, New York Stock Exchange (NYSE) listing rules require audit committees to address oversight policies and procedures relative to risk assessment and risk management, as managed by the company.

Across industries, a large majority of companies perform their risk oversight function at the full board or audit committee level. Not surprising, financial companies, which were the first recipients of the COSO recommendations, have departed the most from the model in which risk oversight functions at the board level are assigned to the audit committee. Approximately 24.3 percent of financial services companies have instituted a dedicated risk committee, compared to 4.8 percent of nonfinancial services and 2.6 percent of manufacturing companies (Figure 9).

Figure 9

Responsibility for Risk Oversight, by Industry

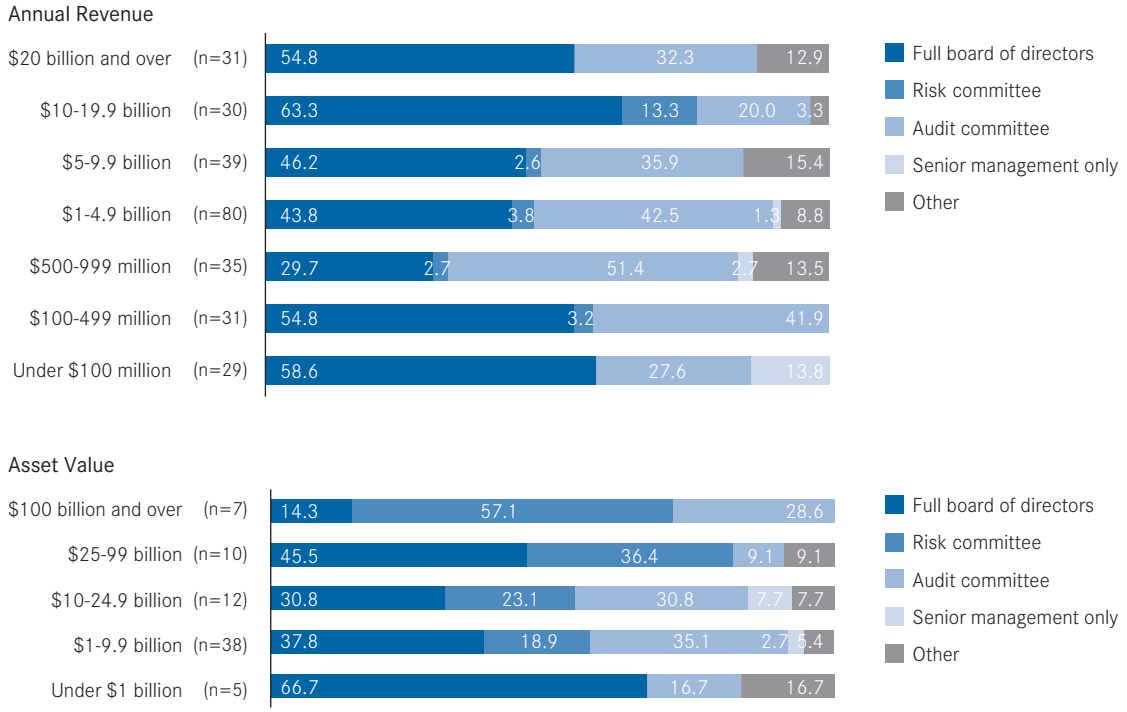


Source: The Conference Board/NASDAQ OMX/NYSE Euronext, 2013.

As shown in Figure 10, in 57.1 percent of the largest companies by asset value ($100 billion or greater), the risk oversight function is assigned to a dedicated risk committee. Only 28.6 percent of financial services companies in this size group continue to delegate risk oversight responsibility exclusively to the audit committee. However, risk committees appear to be used only sporadically across revenue groups, and none of the companies in the largest group (i.e. $20 billion or more in revenue) report having a risk committee.

Figure 10

Responsibility for Risk Oversight, by Company Size



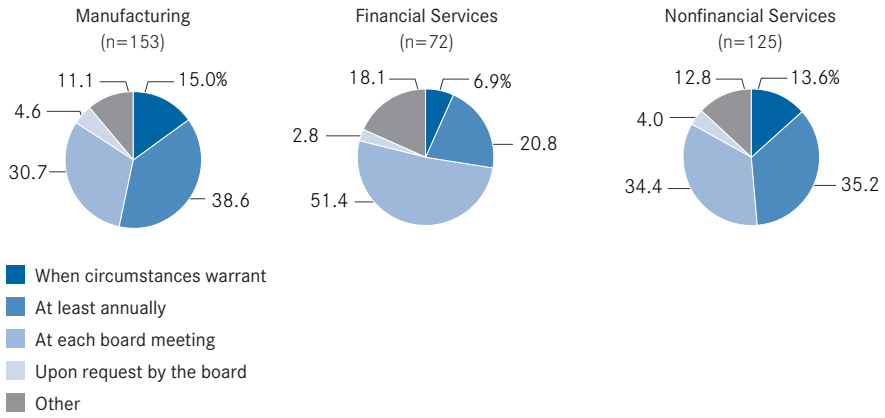
Source: The Conference Board/NASDAQ OMX/NYSE Euronext, 2013.

Frequency of Risk Reporting to the Board

To have strategic relevance, an ERM program should contemplate thorough, ongoing, bottom-up communication on risk. Figures 11 and 12 show the frequency of senior management risk reporting to the board of directors. As shown in Figure 11, financial companies constitute the only industry group in which more than half of companies report on risk at each board meeting and as part of the regular board agenda. The percentage decreases to 30.7 in manufacturing and to 34.4 in nonfinancial services. In both of those industries, more than 35 percent of companies indicated that their boards receive information on risk from management at least annually.

Figure 11

Frequency of Risk Reporting to the Board, by Industry



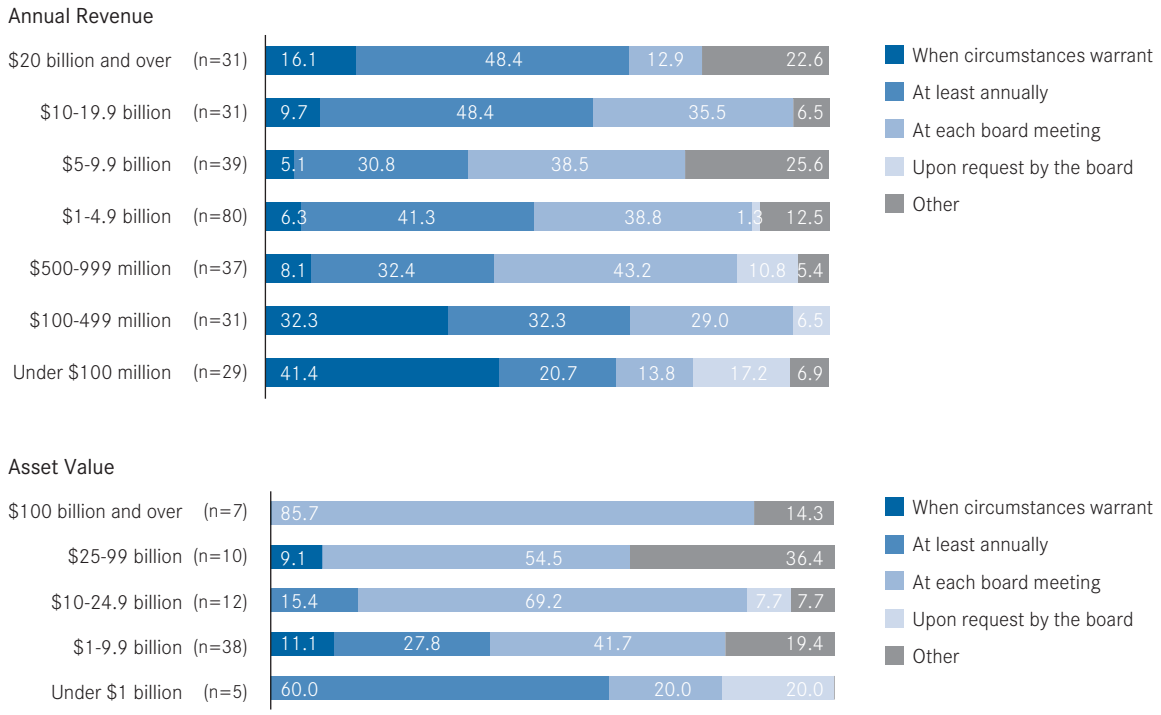
Source: The Conference Board/NASDAQ OMX/NYSE Euronext, 2013.

The size analysis in Figure 12 also contains interesting findings. In particular, there is a moderate, direct correlation between asset value and the practice of communicating risk to directors at each board meeting and an inverse correlation between asset value and annual risk reporting.

In the smallest size group, as measured by annual revenue (less than $100 million), 41.4 percent of companies indicated that management reports to the board on risk issues only when circumstances warrant.

Figure 12

Frequency of Risk Reporting to the Board, by Company Size



Source: The Conference Board/NASDAQ OMX/NYSE Euronext, 2013.

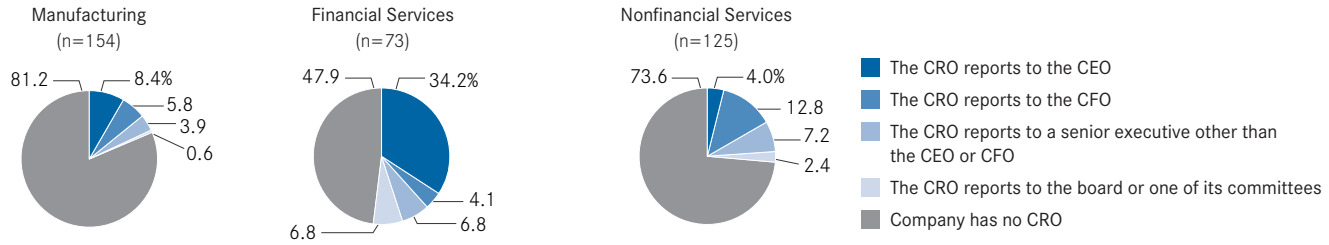
Chief Risk Officer

For many companies, the complexity of ERM demands the appointment to a leadership role of a dedicated senior executive. Where present, the chief risk officer (CRO) relieves the senior management team of a series of direct operational responsibilities regarding the design and implementation of risk management procedures spanning the entire organization.

In addition, the CRO is typically in charge of articulating the ERM development effort among functional and business unit managers. However, as shown in Figure 13, CROs are still uncommon in a large majority of manufacturing and non-financial companies. In those industry groups, respectively, 81.2 percent and 73.6 percent have not instituted this position.

Figure 13

Chief Risk Officer, by Industry



Note: Total may not equal 100 percent due to rounding.

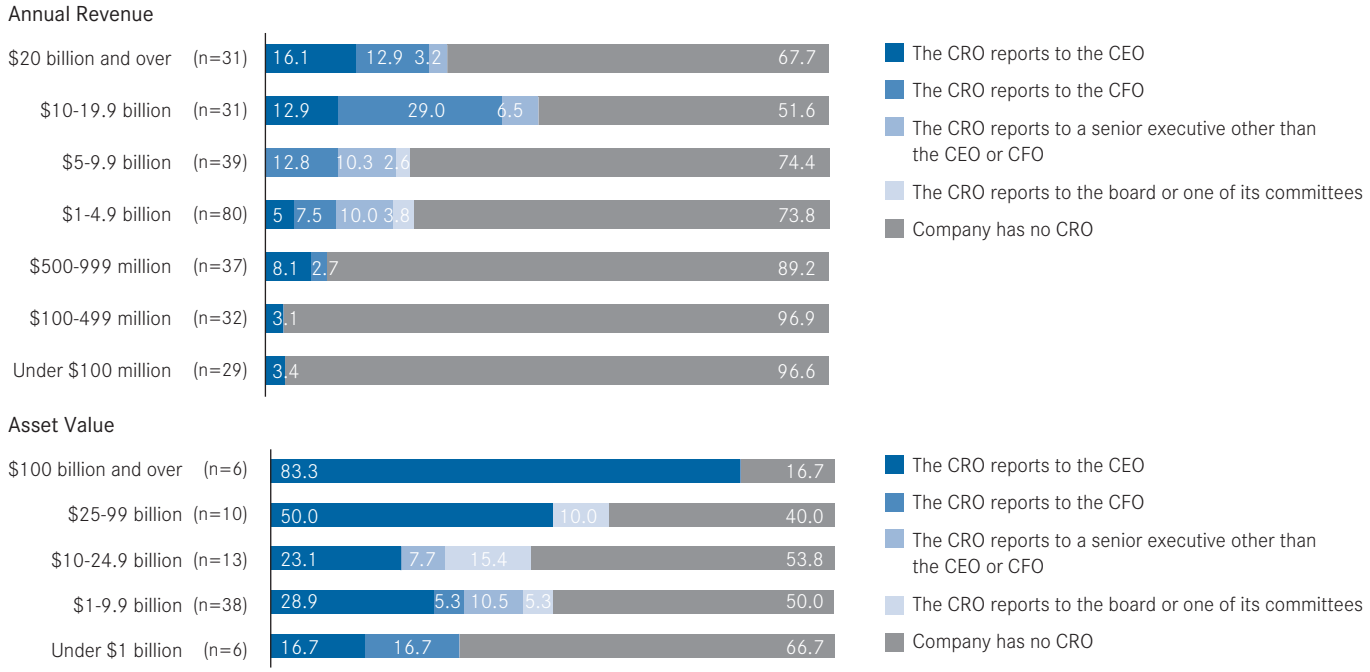
Source: The Conference Board/NASDAQ OMX/NYSE Euronext, 2013.

When analyzed by size (Figure 14), 83.3 percent of financial services companies with an asset value of $100 billion or greater avail themselves of a dedicated chief risk officer; in all of those cases, the CRO reports directly to the CEO.

A CRO who reports directly to the chief financial officer is more common among smaller financial companies (for example, in 16.7 percent of those with asset value of less than $1 billion).

Figure 14

Chief Risk Officer, by Company Size



Source: The Conference Board/NASDAQ OMX/NYSE Euronext, 2013.

ERM Executive Committee

Although most manufacturing and nonfinancial companies do not have a CRO, they are gradually adopting another important guideline for risk management integration—the institution of a risk management committee at the management level. The ERM executive committee is typically composed of a subset of senior management, including functional managers (such as the CFO, chief audit executive, chief information officer, and others) and the risk owners at the business-unit level. This is a relevant board practice because board members with risk oversight responsibilities are usually invited to attend the committee meetings.

Ultimately, the role of the committee is to funnel the diverse intellectual contributions of functional managers to the CRO (or the CEO, if no dedicated position has been created to lead the integrated risk management program). A total of 40 percent of companies in both the manufacturing and nonfinancial services groups reported having an ERM executive committee (Figure 15). There is a direct correlation between company size (as measured by both annual revenue and asset value) and the presence of the ERM executive committee (Figure 16). For example, all financial companies with asset value of $100 billion or greater have an ERM executive committee, compared to 50 percent of those with asset value of less than $1 billion. This data compares to 60 percent of manufacturing and nonfinancial companies with annual revenue of $20 billion or greater and to 10.7 percent of those with annual revenue of less than $100 million.

Figure 15

ERM Executive Committee, by Industry

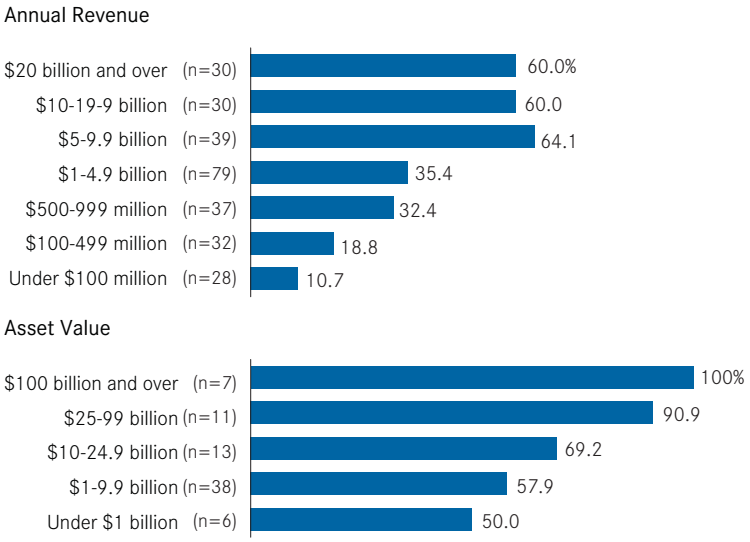
Companies with an ERM executive committee

Source: The Conference Board/NASDAQ OMX/NYSE Euronext, 2013.

Figure 16

ERM Executive Committee, by Company Size

Companies with an ERM executive committee



Source: The Conference Board/NASDAQ OMX/NYSE Euronext, 2013.

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Matteo Tonello is managing director of Corporate Leadership at The Conference Board in New York. In his role, Tonello advises members of The Conference Board on issues of corporate governance, regulatory compliance, and risk management. He regularly participates as a speaker and moderator in educational programs on governance best practices and conducts analyses and research in collaboration with leading corporations, institutional investors, and professional firms. He is the author of several publications, including *Corporate Governance Handbook: Legal Standards and Board Practices* and annual benchmarking reports on director compensation and board practices, CEO succession practices, proxy voting, and corporate sustainability practices.

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