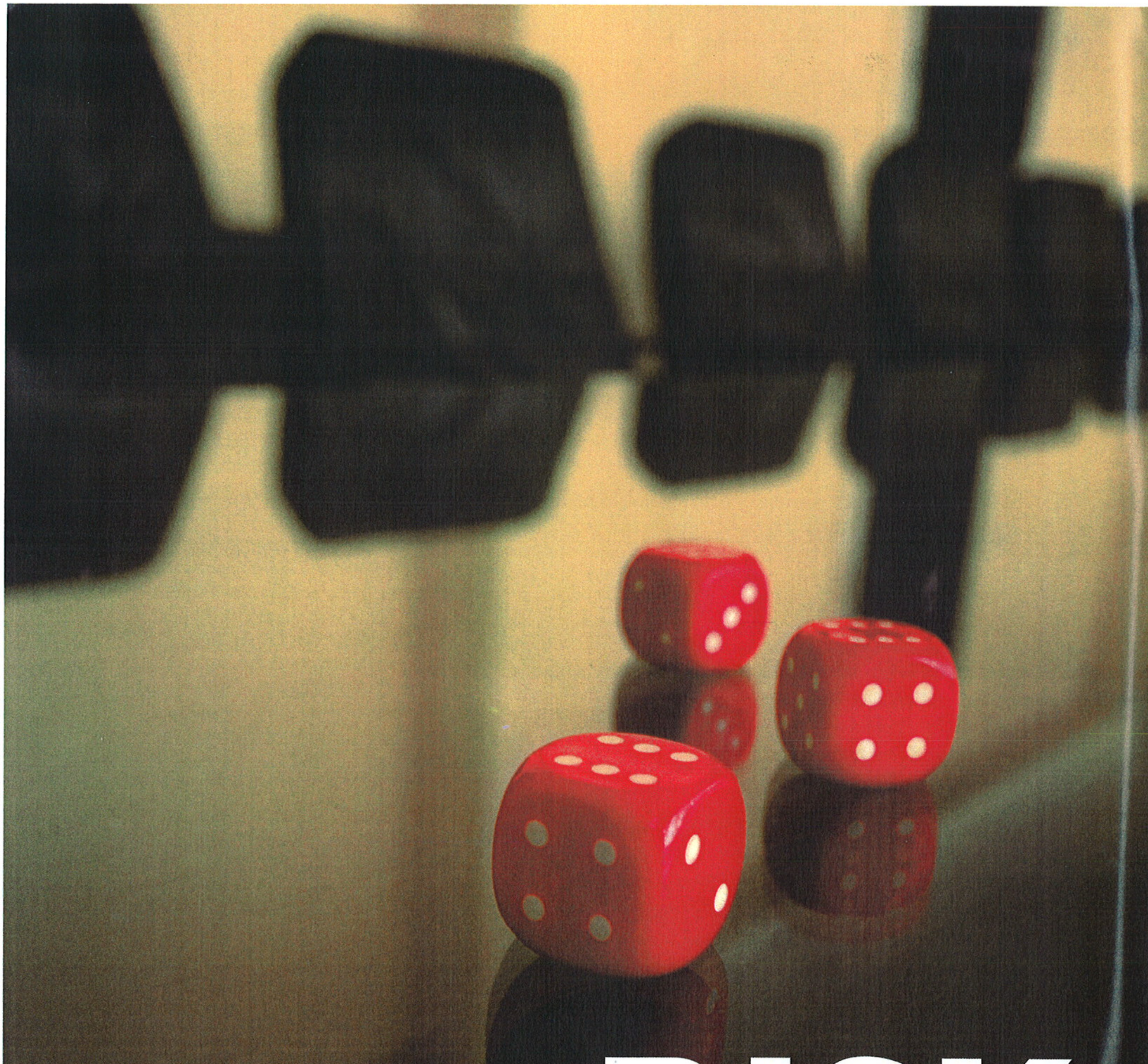

EFFECTIVE ENTERPRISE RISK MANAGEMENT ENHANCES CORPORATE RESPONSIBILITY & PROFITABILITY

By Mark B. Seiger and Charles F. Gfeller

With every major product recall, we are reminded of the importance of effective risk management. For example, these days, the name "Toyota" does not lead to thoughts of shiny new cars; instead, for many people, it generates thoughts and concerns of product defects, product recalls, and Congressional testimony. Failure to properly and effectively manage risks on an enterprise basis can result in serious damage to a corporation's reputation and profitability. We need look no further than the Toyota example to see the importance of staying ahead of risk and managing it properly.

Beginning in early 2010, Toyota suffered through a major public relations and business crisis, when reports surfaced of widespread product defects in a variety of its models. Toyota was perceived to be slow to respond to these reports, and its brand suffered mightily as a result. In February, 2010, Toyota's Chief Executive Officer testified in front of the United States Congress. The following appeared in the National Post following the testimony:

> *Toyota Motor Corp's president apologized to U.S. lawmakers and ended the day in tears, marking a potential climax to his company's safety crisis but leaving it with a long road to rebuild its reputation.*
>
> *Akio Toyoda, peppered with questions about its massive series of recalls, told lawmakers he was "deeply sorry" for accidents and injuries involving its cars and acknowledged it had lost its way in its pursuit of growth.*
>
> *Investors, who have knocked about $30 billion off its market value in the past month, appeared to view Toyoda's hearing as a small step forward in what could be a difficult task of recovering the trust of consumers.*
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> *The National Post, "Toyota Faces Tough Road to Redemption After Grilling," Thursday, February 25, 2010, on-line edition.*

Like many other manufacturers before it, Toyota could have avoided its problems if it had established an effective analytical framework in which to analyze risks on an enterprise basis and take appropriate action to avoid or minimize unnecessary catastrophic exposures. This analytical framework is known as "enterprise risk management." "Enterprise risk management" is the name given to a process applied in a strategic setting across the entire enterprise. It is designed to identify potential events that may affect the company so that the company can manage the risks identified and keep them within the company's acceptable risk appetite, thereby providing reasonable assurance that the company's objectives can be achieved. Enterprise risk management must be embraced and adopted by the company's board of directors to assure that its importance is both recognized and accepted by the entire enterprise.

To be effective, enterprise risk management must be driven from the top down. All areas of the enterprise must appreciate that its activities can, and do, impact the overall well-being of the enterprise. Identification and quantification of risk across the enterprise is critical. Once identified and quantified, appropriate risk management decisions can be made and applied.

To a large extent, enterprise risk management is not a difficult concept. Common sense is a key element of all risk management programs. The ability to recognize and address risk in an appropriate manner is all that is required. The overall twin objectives of enterprise risk management should be corporate responsibility and enterprise profitability. While corporate responsibility should never be compromised, the company's profitability should be somewhat flexible. Risk must be appropriately managed so as to maximize shareholder value. We need only look at the Toyota story to realize that failure to appropriately manage an enterprise's risk will result in a calamity.

What is Risk?

Risk is defined as the uncertainty that exists as to the occurrence of some future event. Businesses are generally concerned with an event that can result in an economic loss, or an involuntary diminution of value, such as the payment of money damages to an injured party who is successful in a civil lawsuit. It is clearly in the best interest of a business to avoid economic loss-triggering events. While such losses can, and do, have an adverse impact on profitability, it is also axiomatic that businesses do not want to see people injured because of their business practices. While we will briefly look at the various alternatives available for handling risk, our main focus in this article will be on risk transfer (insurance) and use of loss-prevention activities (risk management). The principles set forth below are equally applicable to manufacturers, retailers, and service-oriented businesses. Hopefully, this article will heighten awareness of the need to focus on "risk" in daily business decisions. By incorporating risk analysis into daily business decisions, a company will, in effect, be using the analytical framework of enterprise risk management. Hopefully, this framework will become second nature to the company.

Four Alternatives for Handling Risk

The four recognized alternatives for handling risk can be grouped as follows:

1. Assuming risk
2. Risk avoidance
3. Risk transfer or shifting
4. Loss-prevention activities

Assuming risk, or assumption of risk, also known as non-insurance, occurs when a business undertakes to assume a known risk. This is the most widely used of all methods for handling risk. In using this method, the business owner believes that the business either has sufficient funds available to cover any economic loss that might arise should an event occur, or that it is capable of raising such funds. Assuming the risk does not actually reduce the risk, since the possibility of economic loss continues to exist. In reality the business is merely betting that it has developed, or can develop, the ability to cover the loss.

Risk avoidance occurs when a business decides that the risk associated with a particular business or activity is excessive and, therefore, chooses not to get involved with the business or activity. By not undertaking the activity, the business has effectively eliminated the risk entirely.

Risk transfer, or risk shifting occurs when a business pays another (insurer) to assume a risk, which the business

desires to escape. The risk bearer charges a price (premium) for agreeing to assume the risk. While the risk of loss will typically be the same for the insurer as it was for the business that transferred the risk, the insurer typically has superior knowledge concerning the actual probability that the loss will occur. Risk of loss is the uncertainty that in any given time period, actual losses will equal probable losses. Because of its superior knowledge, the insurer should be in a better financial position to assume the risk. However, no matter who bears the risk, the risk still exists.

Loss-prevention activities occur when a business looks at ways to reduce the risk of loss. As mentioned earlier, risk of loss is the uncertainty that in any given time period, actual losses will equal probable losses. Loss-prevention requires a business to recognize and analyze risk, and then look for ways to reduce and/or eliminate it. When it is economically reasonable to eliminate or reduce risk, profitability should be enhanced. Unfortunately, many businesses believe that loss-prevention activities are unnecessary once risk has been transferred. Deciding risk reduction is unnecessary once a risk is transferred, of course, assumes that the ability to transfer risk at a fair price will remain without regard to the size of potential losses. The naïveté of that assumption should mandate that businesses recognize that loss-prevention activities are essential.

Effective Risk Management

To manage risk effectively, a business must recognize the importance of charging someone at a fairly high level within the organization with this responsibility. Ideally, this person should be capable of instilling into all key employees the absolute need to recognize and address risk in all decision-making.

Effective risk management necessitates that a business have in place a discrete methodology to address risk of loss issues. In addressing these issues, one of five types of decisions should occur. A decision is made to (1) not get into the business or activity; (2) assume the risk of the business or activity; (3) transfer the risk of loss to an insurer; (4) implement loss-prevention activities that reduce and/or eliminate the risk of loss; or (5) implement a strategy that combines elements of all four noted strategies. The two most powerful tools used in risk management are loss-prevention activities and insurance. The effective use of these two tools can properly protect a business' bottom line. However, these tools will only work if the risk is recognized in the first instance.

While this article looks at the risks involved with product manufacturing, the techniques discussed herein equally apply to all other areas of an enterprise. Risks exist in employment practices, workplace safety, credit activities, accounting practices, treasury issues (i.e., currency transactions/ hedging), securities, and board of director practices, just to name a few. While all enterprises accept some level of risk the key is to have the board of directors establish the enterprise's appetite for risk and then to stay within the parameters set by the board.

Loss-Prevention Activities

Proper loss-prevention activities should be business specific. A business that manufactures consumer products must be concerned with everything from the adequacy of the design to how the end user actually uses the product. This requires that the designer take into account how the product will be used, the ways in which the product can be misused, the types of injuries which the product may cause, possible alternative designs that could be considered, what testing should be done, what materials should be used in the manufacturing process, how the product should be manufactured, what warning should be incorporated onto or within the product, what the product literature should say about the product, and what should be included in the instruction manual. While it is important that consideration be given to all of these factors, it is critical that a business properly document how it has considered each factor. Preferably, documentation should be developed with the assistance of the company's general counsel. Keep in mind that the product documentation may someday end up being reviewed by a jury in a civil lawsuit.

Another important area of concern for a product manufacturer in risk assessment is product quality. It is important to note that the recognized quality assurance standard is ISO 9000. By implementing the standard, with its mandatory documentation requirements, into the manufacturing process, a manufacturer will have come a long way toward reducing manufacturing defects and, therefore, will have effectively reduced the risk of loss. In the wake of its well-publicized difficulties, Toyota recognized that it had a quality control problem and implemented more stringent quality control measures. While this was a good step in the right direction, Toyota would have been well-served to have enhanced quality control practices in place prior to its problems. In fact, this may have helped to prevent some of the malfunctions that were apparently present in certain Toyota vehicles.

Insurance: Risk Transfer

Insurance is a time-tested and trusted method by which an individual or company may transfer all or part of a risk of loss. Insurance should be part of any enterprise risk management system. Insurance needs should be reviewed on an annual basis with a well-informed insurance broker to be sure that a company is properly protected.

The lower the risk of loss, the lower the premium should be in a particular risk transfer. For cost reasons alone, loss-prevention activities are essential. If a business can demonstrate to an insurer that it has a low risk of loss, the insurance marketplace will assess a lower premium for accepting a transfer of that risk. One way to show that a risk is minimized is through loss prevention, as described above.

For example, in the early days of the snowboarding industry, there was not enough of a loss history for the insurance market to determine an accurate experience rating. Therefore, to a large extent, insurers depended upon preconceived opinions when setting premiums. Most insurance companies believed that snowboarding was dangerous and, therefore, would result in many lawsuits. This resulted in higher insurance premiums. Statistically, however, this opinion was unfounded. Over time, those manufacturers that developed clear and documented loss-prevention standards, usually with the assistance of a knowledgeable insurance broker, were able to obtain affordable product liability insurance. In essence, the experience of snowboarding manufacturers created a paradigm of how effective risk management techniques could assist in the survival and success of a "new" industry.

Structuring the Program

No right or wrong way exists to structure an effective risk management program. All enterprises are different in many respects. What is important is to find a system that works for the individual enterprise. Nevertheless, there are some elements common to effective risk management programs. The following elements must exist:

1. Setting of the enterprise's risk appetite
2. Corporate resolution regarding corporate responsibility
3. Creation of a senior level risk management position
4. Enterprise-wide acceptance and implementation of risk management principles.

It is important for every employee and vendor to fully understand and appreciate that the enterprise is focused on risk management, and its goal is for it to be effective. While this is the stated goal, we must remember that we cannot completely eliminate risk. We need to recognize that in the event that something does go wrong, as a secondary goal, we have put in place systems that will permit the enterprise to better deal with the situation.

For example, a product manufacturer needs to recognize that despite executing product development in an appropriate fashion, it may still be sued for a product defect should someone be hurt. In utilizing loss-prevention techniques, the product manufacturer will have established appropriate product development files. Those files should tell the story of the tremendous effort that the product development team put into the development of the product. In reading the product development files, a jury should come away with an appreciation that the development team exerted care, conscientiousness and concern about the end user. The jury's perception of attentiveness to risk during product development should prove helpful in achieving a successful outcome to any litigation. In effect, perception becomes reality.

Toyota learned the hard way that being pro-active, rather than reactive, is the smart way to do business. As reported in The Washington Post, in February of 2010, Toyota's CEO, in his Congressional testimony, noted that "the company will add a step to its recall process that will take account of customer safety and that it will form a 'quality advisory group' that he will lead, and he said he will establish a new position of 'product safety executive.' Moreover, he said that he will ensure that members of the management team 'actually drive the cars.' But more than anything, he seemed to say, there would be a change in attitude." The Washington Post, "Toyota President Apologizes Under Fire of U.S. Officials," February 25, 2010, on-line edition. Had Toyota embraced an effective risk management system years ago, it may have avoided the problems that it suffered through in 2010.

Conclusion

Irrespective of the type of business, a consistent focus on risk management is essential to survival in a highly competitive world marketplace. If risk management becomes an inherent part of all business decisions, then the business will have planted the seeds for long-term profitability. In short, the "bottom line" of risk management will become an increased bottom line. ■

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