

Too Much SOX Can Kill You

Resolving the Compliance Paradox

In recent years, corporate missteps have wiped out hundreds of billions in shareholder value in industries ranging from telecom to energy to healthcare. CEOs have lost their jobs. Investors have lost their money. Employees, suppliers, and customers have lost their livelihoods. Most important, the marketplace has lost its confidence in the effective stewardship of corporate assets. The result has been an onerous wave of regulatory reform that threatens to hinder growth and innovation, as boards and senior executives scramble to comply and insulate their firms from scrutiny. Is this new, more stringent environment an overreaction to the damage done by a few bad apples, or is the rotten fruit a symptom of a systemic flaw in the governance mechanisms of modern corporations? According to our research and client experience, the problem runs deeper than a few bad apples. It reflects fundamental deficiencies in existing approaches to corporate risk governance.

Even the Best Aren't Good Enough

Booz Allen Hamilton recently completed a cross-industry benchmarking study of leading practitioners in the field of enterprise risk management and discovered that even these exemplars have fallen short in developing a governance agenda and architecture that effectively anticipates some of the most significant risks to their business. While they may have advanced capabilities in

one area—generally in their core business—their systems and processes are often not as well developed in others. And, almost universally, companies fail to look beyond the traditional “downside” risks to their business to consider and incorporate the “upside” risks (e.g., missed growth opportunities) as well. Many companies have yet to achieve a corporate culture that strikes the right balance between control and innovation. The challenge they face is developing a risk governance program that both protects (i.e., eliminates earnings surprises) *and* enhances (i.e., fosters growth) shareholder value.

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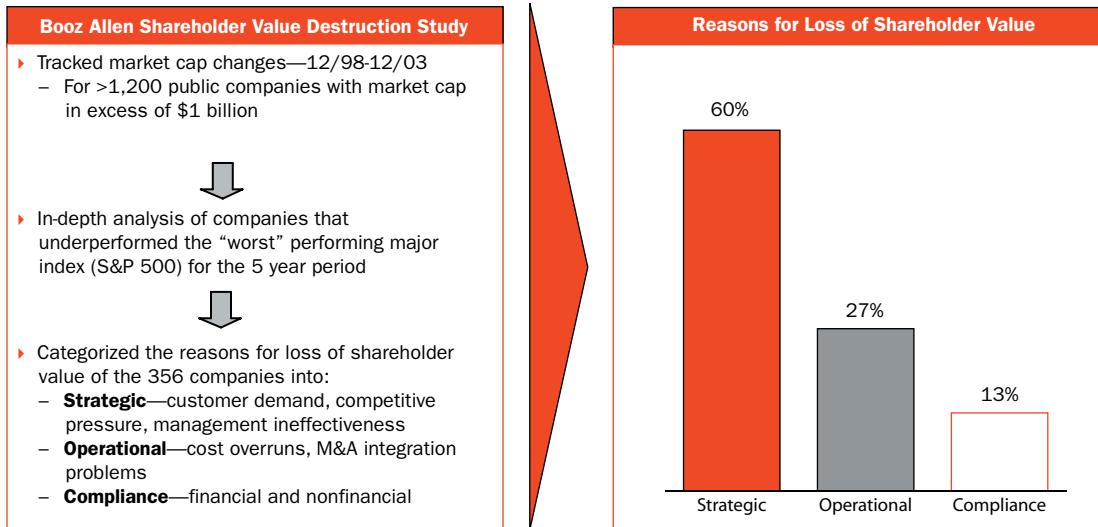
The temptation in reacting to Sarbanes-Oxley and other recent regulatory requirements is to reduce risk management to a “box-checking” activity, an expensive and resource-intensive compliance exercise. That sort of narrow and defensive approach constrains a company's ability to innovate and grow in today's networked, non-stop global economy. To thrive, companies need to adopt a more forward-looking perspective and build better linkages between their strategic planning and risk management systems and processes. Only then can they foster strong yet smart growth.

Compliance Is Not the Culprit

The truth is: More shareholder value has been destroyed in the past five years as a result of strategic mismanagement and poor execution than was lost in all of the recent compliance scandals combined. Recently, Booz Allen analyzed 1,200 firms with market capitalizations over \$1 billion for the five-year period

Exhibit 1

The Real Risks to Shareholder Value Lie in Strategy and Execution



Source: Booz Allen Hamilton

from 1999 through 2003 and identified the poorest performers—the 360 companies that trailed the lowest-performing index for that period, the S&P 500 (see Exhibit 1). Only 13 percent of the value destroyed by these companies resulted from compliance failures; the other 87 percent was attributable to strategic and operational blunders. Clearly, boards and management do not effectively understand and anticipate the full range of risks to their business, nor do they have the systemic capabilities to isolate and evaluate all of them. To manage for growth, companies must embed risk management in the strategic planning capability; they cannot be independent processes. That suggests a more robust and integrated strategic planning process built on a broader understanding of *all* risks to the business—both downside and upside. Board directors and senior managers need to look beyond traditional risks (e.g., credit, physical security) and anticipate earnings driver risks and cultural risks, as well (see Exhibit 2, page 3). Of course, taking this more expansive view is difficult at even the most well-managed companies. How do companies drive growth while actively addressing an expanded spectrum of risks?

Five Imperatives of Good Risk Governance

While the specifics of the risk management agenda and architecture will vary from company to company, our market experience suggests five imperatives for developing an effective risk governance program, one that fosters growth while managing risk.

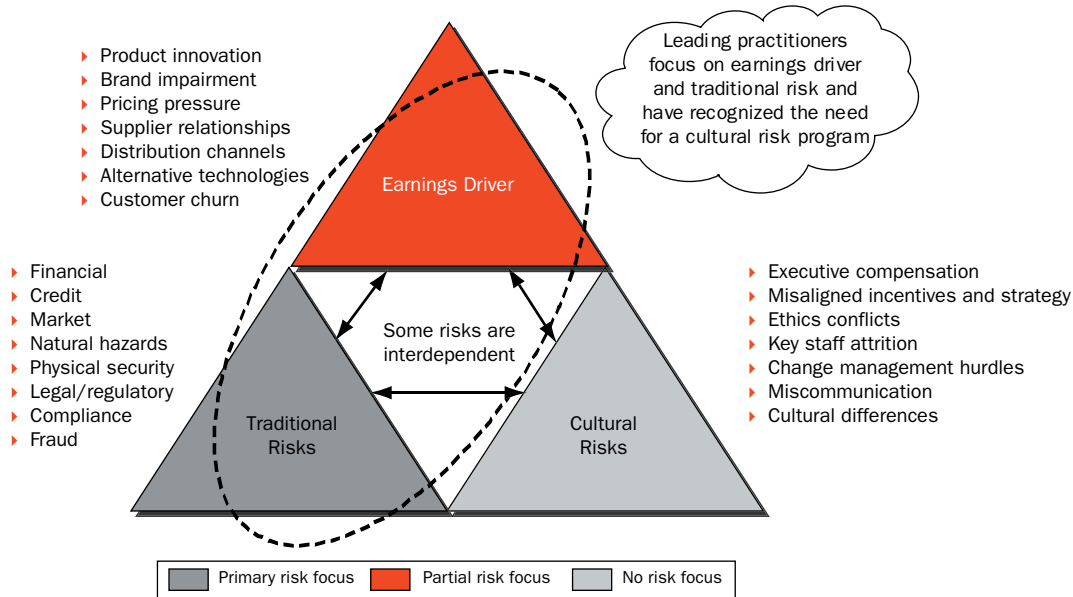
Define what constitutes “risk” and develop early-sensing mechanisms

Most companies need to expand their definition of “risk” beyond the traditional (e.g., financial, legal, market, natural hazard) and consider threats to earnings drivers (e.g., customer churn, price pressure, brand impairment), as well as cultural risks (e.g., misaligned incentives, unethical behavior, communications breakdowns). A comprehensive view of risk should include the perspectives of all stakeholders along every link of the value chain (see Exhibit 3, page 4).

Of course, identifying existing risks is only half the battle. Companies also need to institutionalize sensing mechanisms that anticipate and address these risks. An earnings driver risk assessment, for example, identifies and prioritizes key demand and supply-side risks across the value chain. Cultural risks, while less tangible, are

Exhibit 2

Enterprise Resilience View of Risk



Source: Booz Allen Hamilton

increasingly significant—even the most sophisticated controls and processes break down when behavior is not consistent with strategic and risk management objectives. Cultural risks, their underlying drivers, and management mechanisms to address them can be isolated with a comprehensive diagnostic tool.

Determine the risk agenda

The risk agenda dictates “what you focus on.” After defining and identifying risks, the board and senior management of a company need to establish a common understanding of risk priorities and materiality, which they can then translate into an agenda. Benchmarking leading practices provides a basis for identifying the gaps in the risk agenda and translates opportunities into specific recommendations (see case study, page 5).

Build/adapt the risk management architecture

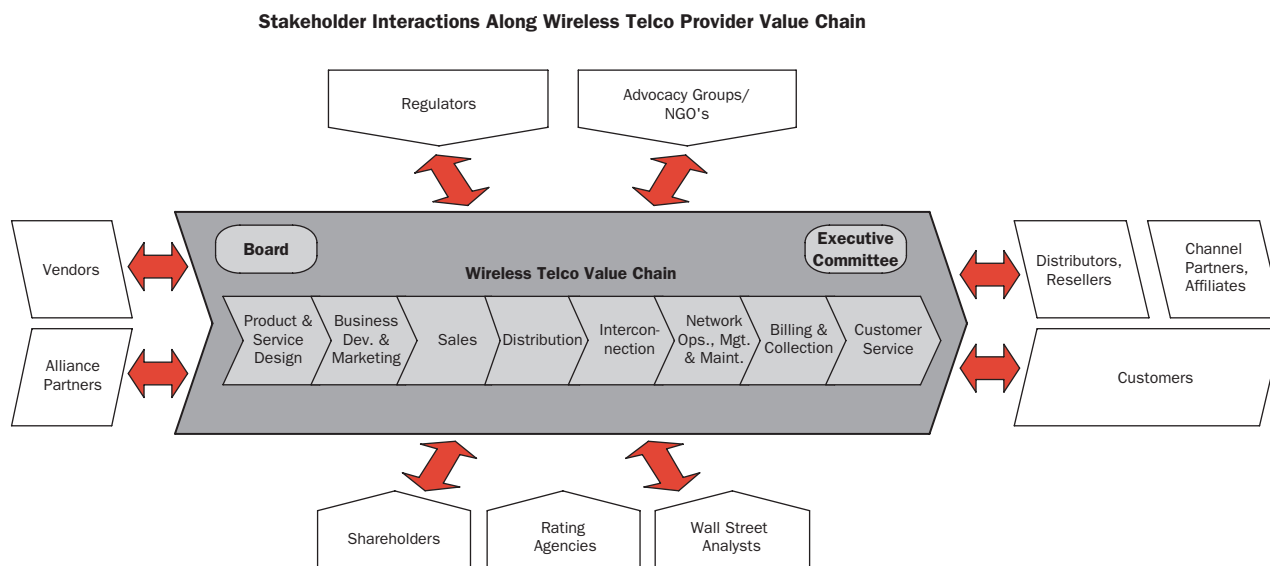
The risk management architecture lays out the capabilities needed to manage risk and encompasses the processes, organization, information/tools, and cultural elements. The architecture is built with the risk

Does your risk management system support your growth agenda?

- **Transparent:** Does it provide insight into material risks and efforts to manage them?
- **Strategic:** Is the approach aligned to corporate strategy and linked to strategic planning?
- **Aligned:** Is risk management activity aligned to board and management risk agendas?
- **Anticipatory and adaptive:** Does the approach provide early warning of emerging risks, and the ability to adapt rapidly to change?
- **Optimized:** Are risk management investments optimized based on strategic goals?
- **Disciplined:** Does the program ensure business discipline and internal controls?
- **Embedded in culture:** Is there a common vision for risk taking and risk management?

Exhibit 3

Comprehensive Risk Assessment Encompasses All Stakeholders Along the Value Chain



agenda in mind, as well as the organization’s “cultural success formula.”

The goal is to identify and prioritize a targeted set of capabilities that are important to managing growth (e.g., strategic risk assessment, sensing capabilities), while building a “culture of confidence” that will help in managing both “downside” and “upside” risks.

Integrate risk management with strategic planning

As we’ve indicated, risk management must be integral to the strategic planning process to not only deliver compliance but also drive growth and shareholder value. If companies fail to incorporate expanded risk management capabilities (e.g., better business intelligence, scenario planning) as they plot their future course, they will almost certainly make poor strategic bets and destroy shareholder value.

Adapt agenda and architecture to changes in the risk environment

Any governance/risk management system put in place today must be flexible and responsive enough to adjust quickly to changing market dynamics.

Delivering Compliance While Driving Growth

It is important to remember that the goal of a risk management agenda is not to ensure compliance with regulatory mandates, but to position the enterprise for uninterrupted growth. This focus has clear implications for the formation of risk agendas and risk management mechanisms, but it also has implications for culture. It requires a shift from a culture of compliance to a culture of confidence—from exclusive focus on controls to an atmosphere in which managers can confidently choose, based on robust analysis and strong corporate values, which strategic risks to take, which to mitigate, and which to avoid.

By taking a diagnostic approach, companies not only avoid negative earnings surprises, but also save significant sums by targeting their investment on the key gaps in their strategic risk management capabilities.

Companies that are successful in establishing an effective program are more likely to protect directors and officers against charges of lack of good faith, build stakeholder trust, capture opportunities, and improve corporate performance and shareholder value over the long run.

Case Study: Rapid Risk Management Diagnostic

A major Fortune 100 company was shifting strategic direction and adopting a more aggressive growth orientation. While its existing risk management systems were highly disciplined, developed, and tied into the strategic planning process, their focus was insufficiently comprehensive and forward-looking to anticipate all the risks to the company's business. The company was about to invest in a million-dollar enterprise risk management program, but it was unnecessary given the strong practices already in place.

Instead, Booz Allen executed an expedited risk management diagnostic, benchmarking the client's existing capabilities and plans against its database of leading practices. Gaps were identified in the company's risk management agenda and architecture. The result is a highly targeted set of recommendations:

- Adopt a stakeholder view of strategic risk
- Align risk management investments with risk priorities
- Link risk management to strategic planning
- Adapt the culture to better balance traditional risk aversion with a more growth-oriented mindset

The company prioritized for implementation a select set of capabilities critical to managing growth (e.g., strategic risk identification and assessment, risk-sensing capabilities, linkage between risk management, and strategic planning). The result: a closer linkage between the company's risk and strategic agendas, a board more comfortable that management is effectively controlling both downside and upside risk, and considerable savings in terms of time and money.

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