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Turning risk into advantage: A case study

*KPMG's Evolving World
of Risk Management*

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Using a case study example, this white paper examines how companies:

1

Fail to understand and anticipate risks to the organization

2

Approach risk management in a siloed versus holistic manner, resulting in internal miscommunication about risk and other inefficiencies

3

Need clear accountabilities and responsibilities for risk management to be effective

4

Have yet to adapt and align their governance and control infrastructure to facilitate management of risk

5

Need to balance risk and return through an understanding of risk and what the appetite for that risk is as set out in the strategy



Executive summary

The recent recession exposed the weaknesses and vulnerabilities of many companies that miscalculated their risks on the crest of the boom years. Companies are learning that to compete in the current volatile environment requires a new integrated risk management approach. As part of its governance framework, management needs to identify strategic, operational, and financial risks and their interdependencies before they become insurmountable and to implement actions to mitigate them in advance while maintaining strategic direction and meeting performance goals.

This complex subject is difficult to discuss in generalities. It is more illustrative to examine a specific case study company that was able to develop better risk management processes and overcome a significant strategic threat. This white paper examines a company that lost, and then regained, its market leadership position during a tumultuous time. But this is not just an example of good implementation of specific programs. It's also an example of how quick action to mitigate risks in advance allowed a smooth transition to a new and unfamiliar business model and perhaps saved the company from perishing outright.

Background

Our case study company overcame the challenges of the downturn and its declining market share because it quickly realized the markets in which it had traditionally operated had changed so significantly due to technology that the company was no longer the market leader. Companies not previously recognized as competitors were able, using a new technology, to grow into formidable competitors in our company's traditional markets before our company identified the emerging risks and effectively mitigated them.

Our company eventually faced the choice of either sticking to a slowly declining market share as its markets dried up, or taking a major risk and entering a new era of technology and markets by playing catch-up. In formulating a turnaround, our company adapted by analyzing and leveraging its existing technologies and core strengths to target market segments with new disruptive technology that it could develop to compete.

The company weathered a reputational challenge while developing new products and technologies and proactively worked with its clients through beta phases to launch new products as quickly as possible without compromising on its quality standards. The company also implemented a bold turnaround plan that had a slim margin of error to allow it to continue being successful. Management needed to understand the drivers of error (risks) and how much error the company could tolerate (appetite for risk) before it implemented alternative plans.

Seeing the light

As the recession ebbed and new opportunities appeared on the horizon, our company had weathered the worst and was well positioned for the future. A key realization was this: *The transition worked because management made risk management everyone's job.* A thorough understanding of risk and its management by the executive team influenced the overall corporate culture by setting the right tone-at-the-top and has helped refocus the company's efforts on what's most important for success and what constitutes acceptable return for the risks necessary to achieve that success.



Part 1 – A failure to anticipate risk

1 Fail to understand and anticipate risks to the organization

Only a few years earlier, our case study company stood content with its market-leading position and believed it was well equipped to weather any market storm. Historically, the company had always been successful. It had built some very strong competitive market positions, possessed a strategy that had always worked, and firmly believed that it needed to continue doing what it was doing to remain successful.

The company competed against a number of technology companies that it regarded as insignificant. But as the technology evolved, these “insignificant” companies became more formidable competitors, and the market-leading company began to suffer competitive erosion.

Analyzing why the company had not identified this as a top risk after the fact revealed several critical weaknesses in how it traditionally identified, assessed, and managed risk:

2 Approach risk management in a siloed versus holistic manner, resulting in internal miscommunication about risk and other inefficiencies

- *Lack of holistic risk awareness* – No one management level group was tasked with identifying, assessing, and managing risk holistically. Risks were identified by many different individuals, but that information was escalated only within their work group or silo, not to the company as a whole. As a result, that risk and its interdependencies with other risks were not identified due to the siloed nature of the business.

3 Need clear accountabilities and responsibilities for risk management to be effective

- *Lack of coherent communication* – Although the sales staff was aware of the rising threat of new technology after talking to customers who were transitioning to the new technology, the message became diluted and changed as it rose within the company. Worse, since its products had traditionally been market leaders, the company had not required the input of sales staff, thus overlooking a well-established feedback loop from the sales team regarding emerging competitors.

- *Lack of accountability* – As sales declined, the lack of clear accountability prompted several questions. Was it the sales force's problem because they couldn't manage their relationships? Was it the marketing team for failing to keep boosting mind share? Or was research and development at fault for failing to anticipate the new technology? In sum, the company's risk management process was too piecemeal to be effective.





Seeds of the problem

To more completely understand why this company ignored the writing on the wall, it's important to look at its approach to risk management. Similar to its market-leading dominance, the company's approach to risk management was traditional. It understood risks such as poor quality, noncompliance with regulations, lack of cash flow, and other financial challenges. But these were not the only risks facing the company, and it either did not understand or seriously focus on how different risks—including external forces that impacted strategic, operational, and financial risks—interacted with one another. Furthermore, the lack of a clear risk ownership, or a forum in which to discuss risk, made it exceptionally challenging for management to address new and emerging risks.

In addition, the company's governance structure did not support a robust risk management process, which impacted other areas of the company such as the control environment and infrastructure. Risks that were unlikely to have a large impact on the company were being heavily controlled while those with long-term impact, such as evolving technology, were overlooked. Weak or nonexistent risk management policies resulted from the lack of ownership, accountability, and management responsibility of specific risks.

How the company came to be in this position was completely logical. Essentially, the company's formula for success had always worked and few challenged the need to change it. The company also believed that, as the market leader, it could afford to be second to react in a shifting market because it could always draw upon its massive resources to stay competitive. But the company's logic failed to anticipate a rapidly changing marketplace.

The problems mount

Initially, the competitors held such a small market share that our company allowed them the space to make inroads. Slowly, however, the problems began to mount. The company's long-standing group of customers started to prefer competing products that were more expensive with fewer features and based off different technology platforms even though their perceived quality was, in theory, not as good as what our company sold. However, the one big blindsiding issue was that their competitors had a similar product using a different technology.

Slowly, incrementally, our company began to lose market share and its own previously impervious image in the retail and commercial market. Still, the company did not think that change in technology would impact its products in the way it eventually did. Globally, technology as a feature of this market was changing at a lightning pace in comparison to previous technology changes. This resulted in a substantial portion of our company's product portfolio becoming obsolete much sooner than anticipated, catching the incumbent management team by surprise. Our company quickly found itself short on the necessary skills to master the new technology and compete in its traditional markets against increasingly bolder competitors.

4

Have yet to adapt and align their governance and control infrastructure to facilitate management of risk

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Need to balance risk and return through an understanding of risk and what the appetite for that risk is as set out in the strategy



Part 2—Management changes its focus on risk management

As time—and money—ran out, our company's management team realized it faced two hard choices. It could wind down painfully and eventually disappear. Or, it could make a bold bet on developing new products with disruptive technology that could compete in new-to-them established markets. The second choice meant working without the security of a stable financial position to absorb mistakes. Put simply: The margin for error was slim.

The management team and board focused immediately on understanding the risks inherent in the second choice and making sure that they were all in agreement about what needed to be done and upon which products to place its bets.

As part of its turnaround, our company's strategy was underpinned by a select few products that management believed to be its best shot at competing successfully in a market now dominated by a technology our company had not perfected. Going forward, management's strategy was threefold:

- Identify the company's best options given its current in-house skills and existing technology that could be transferred to the new platform
- Determine which markets and products would be most open to a new disruptive technology
- Discover how the company could best leverage the existing supply and distribution chain established by competitors to lower its product costs to be competitive.

Our company understood that it had to invest in more than one product but couldn't afford to back an endless array of products. So, management selected only a handful, basing its criteria on areas that its competitors had neglected and using disruptive technology in those areas where its products were needed. The company was very focused on the costs associated with developing a technology that it was already familiar with and thus could develop more inexpensively. The company also knew what the break-even point was until the product became profitable and looked ambitiously at cross-selling opportunities. Only time would tell which products succeeded, and management was prepared for a certain amount of failure. Essentially, management realized there was execution risk in a good decision and it identified tolerances to help manage the risk of not achieving its goal.

A new strategy and new risks

Upon implementing its new strategy, our company faced the risks associated with adopting a new technology and managing its reputation. First, it had to create new products based on a new-to-them technology and launch these products into the marketplace as quickly as possible in order to earn a return on investment and take market share away from its competitors. Second, the company had to monitor its reputation in the marketplace to make sure it was not losing any former or current clients by taking a new direction.



Faced with this reality, the management team:

- Started to develop an understanding of its risks and how they were interrelated, and develop organizational risk intelligence based on experience with risk, knowledge of the industry, and business relative to those risks
- Began to look at its strategic objectives and evaluate the threats, how those threats linked to the risks it had identified, and what its tolerance was to such risks
- Realized that it would need quick and accurate risk information to assist it in fine-tuning its postlaunch strategy. They tweaked existing risk escalation processes and early warning systems to provide this information
- Determined, along with board review, what the key risks were to the company, and how they as a team were going to manage these risks to be successful.

Companies should establish a management-level risk management team

Management started to clarify who was responsible for which risk, leading to a redraft of certain policies and procedures and wholesale changes as the risk owner was empowered to make changes to the company. After management determined the risks to the company, its strategy called for the company to take on additional risk to generate the return it needed. Developing an understanding of what risks the company sought and how to measure them greatly increased management's insight into the effectiveness of its strategy, which was especially crucial given the company's precarious financial situation.

There should be alignment of the governance and control infrastructure

The challenge of embracing a new technology and producing new products can be formidable for any company. It can be particularly critical for a company that is literally betting its future existence on success. Time was essential. Faced with depleted capital and decreasing cash flow, our company did not have the luxury of time perfecting the technology and the quality of its products because of the risk its technology might become obsolete before or shortly after the new products were launched.

In short, the company had to develop a new strategy with a robust risk management process embedded in the business to ensure its success over the short and long term (see sidebar below). Ironically, the company committed to this turnaround plan *before* the economy began to falter. Without this change of approach to risk, it is debatable if the company would have survived the crisis as well as it did.

Risk management needs to be embedded in the business

The Risk Management Initiative

As highlighted in the table to the right, when the more formalized risk management initiative first debuted during the 1990s, it was often a functional responsibility that focused on certain areas such as internal audit, fraud detection, disclosure reviews, and financial risk management through diversification and hedging. It rarely addressed operational or strategic areas. Similar to the quality initiative in the United States, companies began hiring chief risk officers (CROs) or delegating existing resources to the task of overseeing risk management within their organization.

How risk management is evolving?

Today	Future
<ul style="list-style-type: none"> • Functional responsibility • Performed offline • Existing tools are for financial controls • Separate process • No continuous auditing/continuous monitoring (CACM) 	<ul style="list-style-type: none"> • Integrated into strategy and embedded in the business • Everyone's job • Not a parallel process • Better use of tools to determine the root cause of the risk • CACM • Tools to measure risk in real time as it develops



Part 3—Determining the risk appetite in a new strategy

Deciding when to launch a product to capture market share and realize the higher margins associated with new products required the company to understand how much risk it was prepared to take in terms of customer frustration with technology bugs or a competitor launching a product before them.

Risk appetite and risk tolerance

The company formally developed its risk appetite to assist all parties in understanding its position in this situation. The risk appetite statement articulated that internal quality measures would not be compromised in the launch of a product, although a product with fewer features could be launched provided that product gave the end user a unique customer experience.

Companies often debate the difference between risk appetite and risk tolerance. Risk appetite is generally regarded as the amount of risk that a company is willing to assume over a period of time and in the pursuit of its mission, while risk tolerance is generally regarded as the degree of variance from the level of risk appetite that a company is willing to accept.¹ Hence, a company may have a risk appetite statement about missed earnings announcements and a risk tolerance that states acceptable variations between X and Y cents per share.

Companies should develop practical risk appetite statements and tolerances

Generally, the tolerances to measure risk were supported by the company's existing early warning systems and did not result in any new or add-on processes. The tolerances that management required to evaluate the effectiveness of the strategy were not easily obtainable from the information systems. Furthermore, in some cases, the tolerances deemed important by management were not metrics communicated as important to the staff. This realignment of what was important from a risk perspective led to a change in risk culture.

When setting up its risk appetite, the company adopted a top-down approach. First, it classified all risks into categories and ranked each risk according to its impact and likelihood of occurring on a residual basis.² Second, management identified the top risks, or those with the largest potential impact or greatest likelihood of occurring. From this list, they identified either specific risks or risk categories for which a risk appetite statement was required.

A key question that was asked during this process was: *Which risks do we mitigate and which do we optimize to boost our return?* The company created risk appetite statements for specific risks such as earnings volatility, liquidity and cash flow, product quality, and regulatory compliance.

When developing the statements, the company followed leading practice and created a worded statement for each risk appetite. The intention was to create a guiding principle that should not change in the short term. To support the risk appetite statement, the company developed tolerances to provide a range within which acceptable deviations from the norm could be identified versus those deviations, either positive or negative, that would require management's attention.

¹ Report of the NACD Blue Ribbon Commission on Risk Governance: Balancing Risk and Reward, October, 2009.

² The residual basis is represented by the gross risk minus management's actions to address that risk, which results in a net or residual value.



Since new products using the new technology were a cornerstone of the turnaround, the company developed its quality risk appetite statement containing its view on:

- *Quality*—products launched had to meet an internal level of quality and a certain level of quality as perceived by the customer.
- *Time-to-market*—the company had to develop products within the time periods set.
- *Cost of development of new products*—budget constraints had to be met.

The company then identified a couple of metrics for each element of the risk appetite statement, including:

- *Quality*—number of defects, failure rates, customer satisfaction.
- *Time-to-market*—which key milestones per their product development methodology had to be met, i.e. level 3 and 4 milestones.
- *Cost of development of new products*—percentage overruns and dollar limits on additional funding.

Management then reviewed all current information related to new products to determine what metrics existed and which existing processes it could leverage to build the early warning system for the risk. The management team finally debated which of the three criteria for new products was the most important. In their case, quality came first, followed by time and budget.

In arriving at this ranking, many in management individually believed that the budget was the binding constraint given the company's position. As a team, however, they were able to ascertain what level of investment over what time period they were prepared to strive for quality. In hindsight, the team said this was a valuable realization because it prevented them from launching sub-quality products simply because they wanted to be within the budget as they had in the past. Further, it prevented them from developing the perfect, flawless product that would take a major time investment and result in them missing the market opportunity as they had in the past. This new realization allowed our company to launch products within its internal quality specifications that appealed to customers in a timely, budget-orientated manner.

This risk awareness, coupled with the collection and measurement of experience, greatly enhanced management's risk intelligence and helped it streamline its assessment processes and be confident it was focusing its activities on the company's key risks.

The realization that risk management was everyone's job and that the company was continuously getting more and more risk information allowed it to proactively manage its risk going forward. All companies were impacted by the 2008–2009 financial crisis, and our case study company was no different except for this: Had the company not been in this phase of its turnaround and proactively managing risk, it might have perished altogether.





Questions leaders should ask to determine a company's future risk appetite.

1

Has management presented a prioritized inventory of risks to you, the board, for discussion?

2

Do the board and management engage in robust discussions on the strategy including assumptions in the strategy, risks to the strategy, and risk appetite prior to finalizing the strategy?

3

Which risks inherent in our strategy do we seek to generate return from and which do we avoid? How do you measure where you stand?

4

Do you use scenario analysis ("what if" discussions) appropriately to identify risks and alternative strategies in the event unforeseen events occur?

5

Are there clear roles and responsibilities for ownership of the risks to our strategy and are these resources involved in the conversations?

6

Are resources (capital, talent, etc.) appropriately allocated to mitigate key risks to the strategy?

7

Is there sufficient detail in the reporting packs to assist you in understanding the risks and how these are changing over time relative to your appetite?

8

Does our culture reflect our risk appetite?

9

Is there a clear understanding of what events/triggers will bring an issue to the board's attention?

10

Looking back, have losses suffered been in line with expectations and appetite?

Conclusion

Unlike many companies that stumbled and fell during the recession, our case study company made some critical mistakes and then saw the light, learning how to manage its risks while implementing a new strategy. During its turnaround, the company learned several lessons that ultimately contributed to its renaissance, including:

- Risk management needs to be embedded into the business
- Companies need to make risk management everyone's responsibility as part of the overall management process
- Leadership teams (e.g. risk management committees) should collaboratively identify and discuss new risks and ways the company can address them
- There should be alignment of the governance and control infrastructure
- Companies should develop practical risk appetite statements and tolerances

In conclusion, our company learned that risk influences management's decision-making capabilities and architecture. Making decisions is a step-by-step process, almost like a decision-making supply chain. Hence, the difference between a good decision and a bad decision is often based on the strengths and weaknesses in the specific steps that lead to a desired outcome. A robust risk management process can help companies in both good and bad times and enable them to gain competitive advantage.

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