

Strategic Business Risk

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What is Strategic Risk?

- Risks that could cause severe financial loss or fundamentally undermine the competitive position of a company
- The risks that industry-leading firms must manage if they are to maintain their dominant competitive positions
- Strategic risks may cause dramatic changes in the business environment or outright business losses
- Examples of strategic risks to business include threats of:
 - physical loss due to war
 - financial loss due to dramatic market movements
 - market share loss due to the sudden entrance of new competitors
 - planning and resource allocations
 - major initiatives
 - mergers, acquisitions, divestitures
 - communication and investor relations

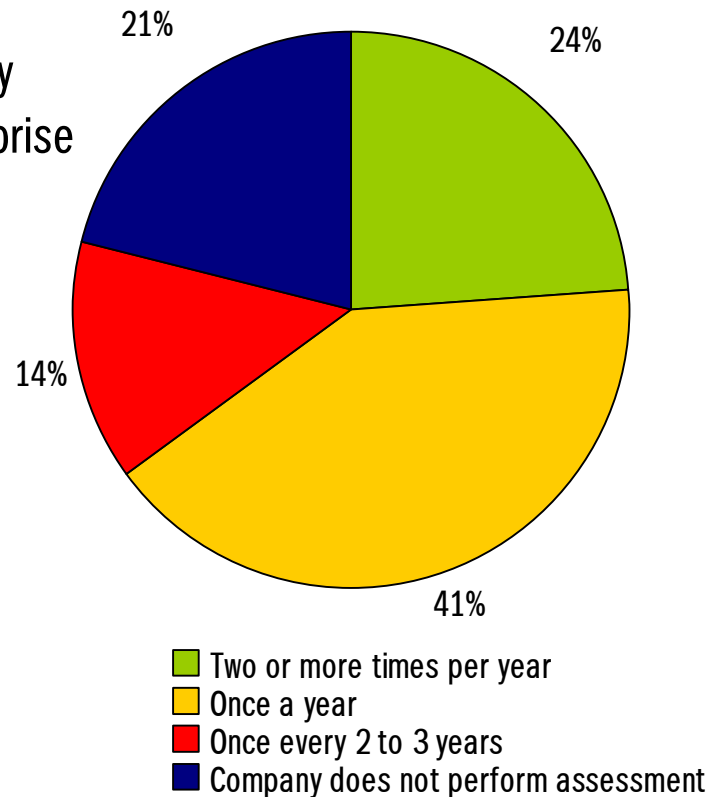
The Growing Importance of Risk Management

- Risk is an inherent part of business
- It is now garnering greater attention because:
 - Global economy = growing interdependencies, scale, and speed of change
 - Regulatory change = increased exposure for management and board members
 - Effective risk management = competitive advantage
 - Better controls
 - Better information
 - Better decisions
 - Better communication to the market
- Most focus has been on financial and regulatory/compliance risk
- Strategic risk thinking has been at a macro level
 - Lacks implications for sector and management action

Is there a Strategic Risk Management Gap?

An enterprise risk assessment (ERA) is a key tool, but...

Q: How frequently does the company conduct an enterprise risk assessment?



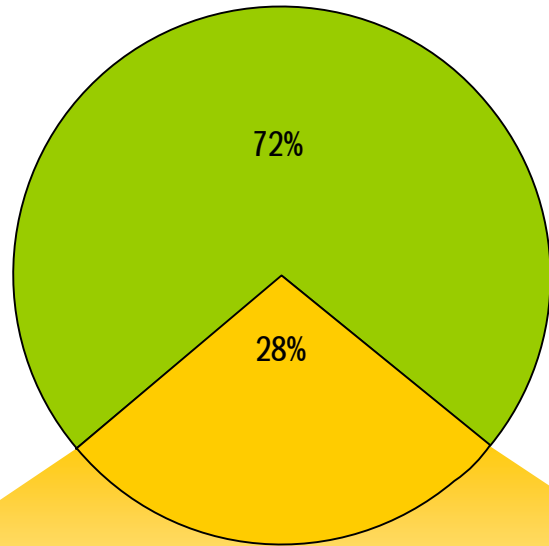
- One in five respondents do not perform a risk assessment
- Over one-third of the respondents do not conduct an annual risk assessment

Source: Ernst & Young, 2007
From Compliance to Competitive Edge

Is there a Strategic Risk Management Gap?

An ERA does not always go beyond financial reporting

Q: What is the focus of the risk assessment?



- 72% of respondents focus on all four areas of risk in their assessment
- 28% of respondents do not focus on all risk categories

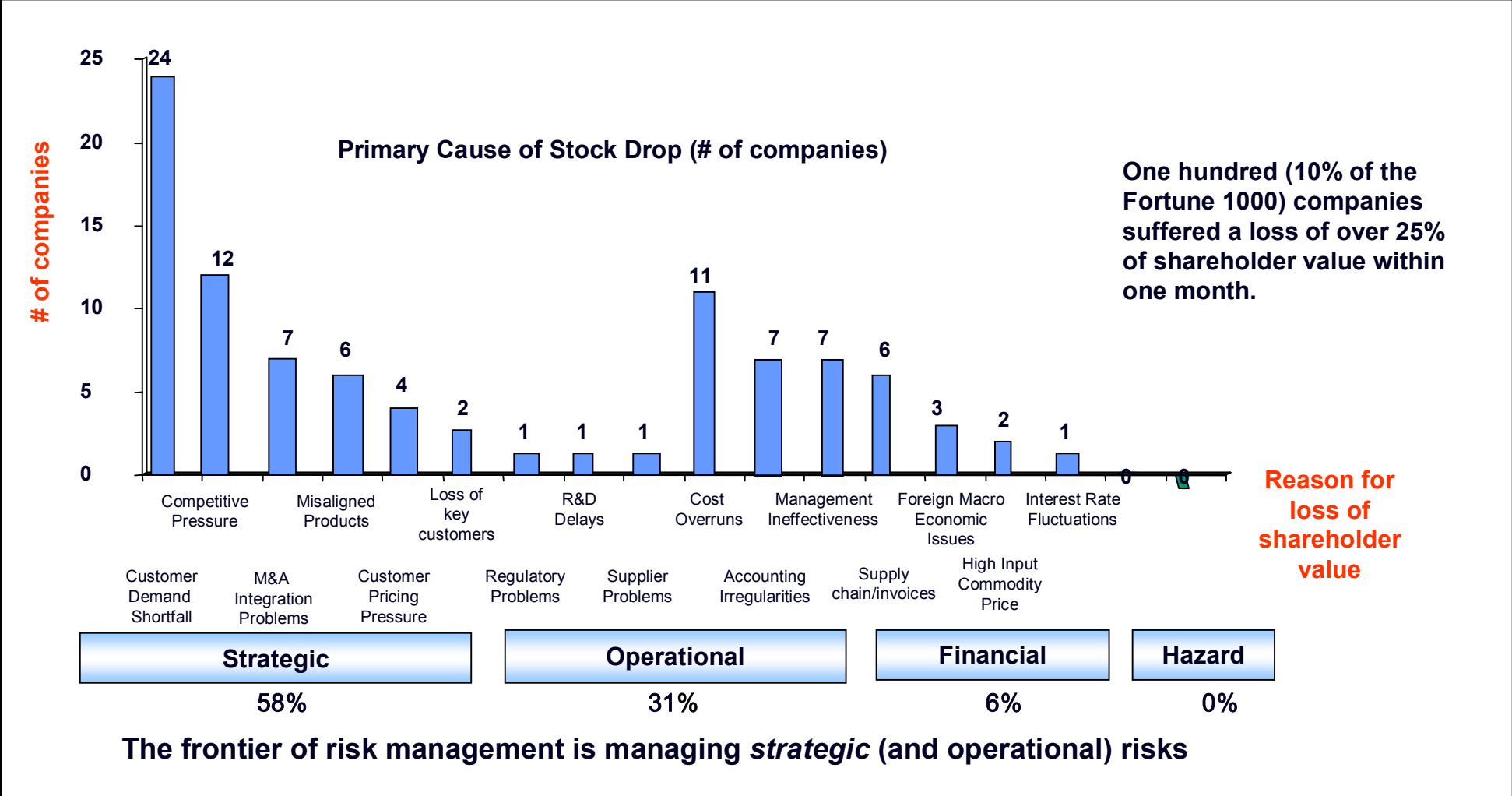
Focus of Risk Assessment		
	Operational / business risks	22%
	Financial / financial reporting risks	20%
	Compliance risks	14%
	Strategic risks	7%

- All Risk Categories
- Separate Risk Categories

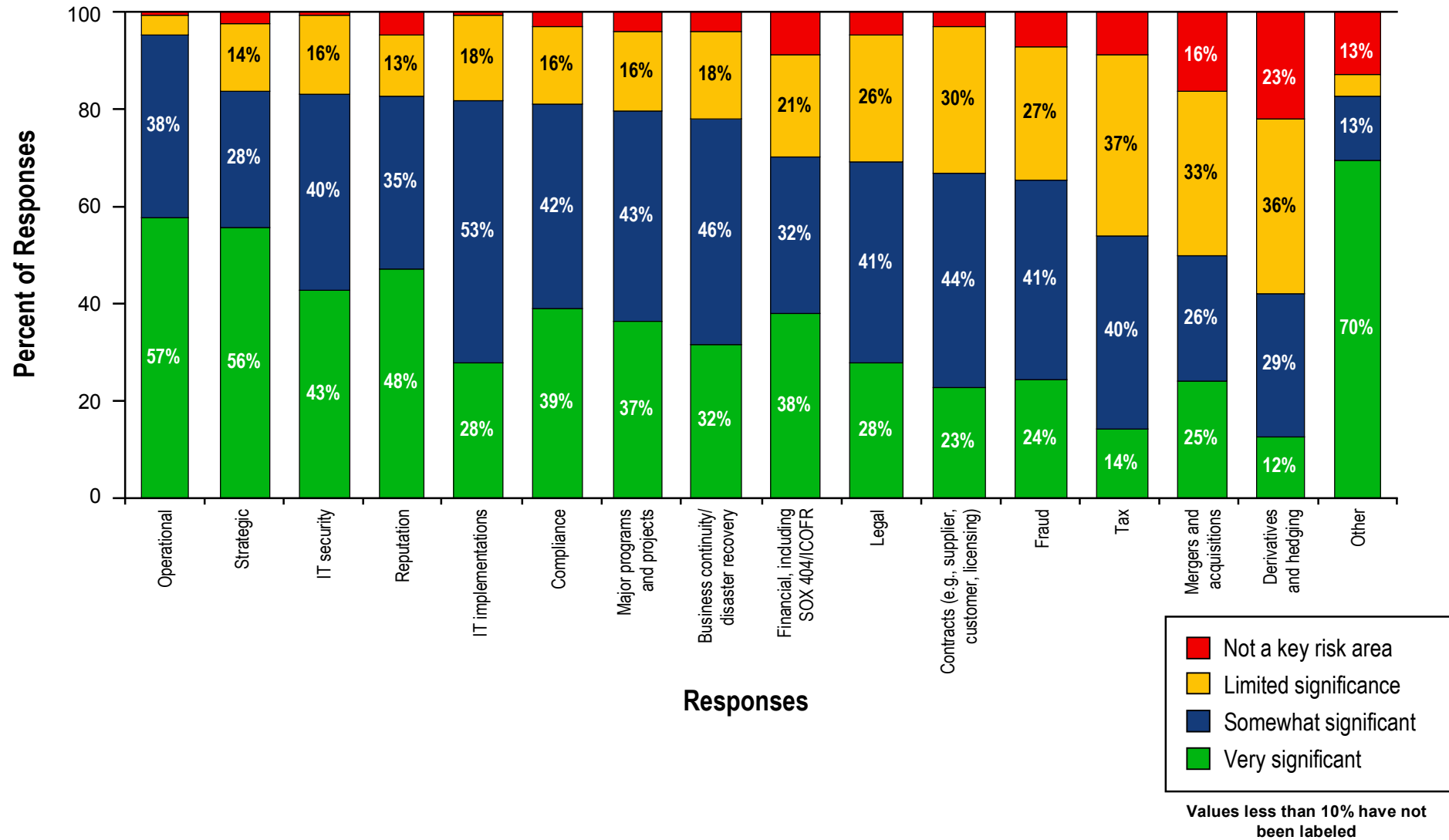
Note: Multiple responses were possible

Source: Ernst & Young, 2007
From Compliance to Competitive Edge

Illustration of Strategic Risks on Stock Price



Sample Survey Results of Significance of the Key Risk Areas



The Case for Strategic Risk Management

- How organizations deal with strategic risk is a defining factor
 - Organizational value shifts (positive and negative) are driven largely by strategic events
 - Most companies are doing too little in this area
- All companies should have strategic risks on their radar – and an ongoing process to identify and manage those risks
 - Today's strategic risk may be tomorrow's opportunity
- Organizations should prepare for risks not currently “on the radar”
 - These risks could rapidly become critical
- A formal process and comprehensive framework for managing risk adds value – even if the events never happen
 - Coordinated risk management can lead to process improvements

Our Approach – Risk Identification and Prioritization

Industries
Banking & Capital Markets
Technology
Insurance
Consumer products
Oil & Gas
Asset Management
Automotive
Media & Entertainment
Telecommunications
Utilities
Pharmaceuticals
Real Estate
Biotechnology

- With with Oxford Analytica, we interviewed more than 70 analysts
 - Specialists in more than 20 disciplines and 12 industry sectors
- Interviews were open-ended
- Analysts were asked to:
 - Evaluate the most important strategic challenges for global businesses
 - Rate the severity of these risks for their sectors
- Risks with greatest impact for the largest number of sectors are “top risks for global businesses”

The Top 10 Strategic Risks (“Opportunities ?”) for Business

1. Regulatory and Compliance Risk
2. Global Financial Shocks
3. Aging Consumers and Workforce
4. Emerging Markets
5. Industry Consolidation/Transition
6. Energy Shocks
7. Execution of Strategic Transactions
8. Cost Inflation
9. Radical Greening
10. Consumer Demand Shifts



A snapshot of the top 10 strategic business risks placed in three categories:

- Macro threats- geopolitical and macroeconomic
- Sector threats- trends or uncertainties re-shaping an industry
- Operational threats

1. Regulatory & Compliance Risk

- As companies become more global, compliance is a greater challenge – forcing them to manage diverse regulations in many markets
 - This alone creates redundant compliance and regulatory risks
- Regulatory intervention could reshape the competitive environment and change business models in some sectors
 - Will stricter regulatory intervention fundamentally change the viability of current business models through shifts in the competitive environment?
- Need to examine the multiple geographic markets your company operates in and determine impact of different regulatory requirements (IFRS, J-SOX, SOX, 52-109, Solvency II etc)
 - This risk is driving risk convergence initiatives to coordinate processes, develop common IT platforms, reduce redundant reporting activities, and provide more comprehensive enterprise-risk reporting to senior management and the board.



2. Global Financial Shocks

- Few sectors could escape the impact of major global financial shocks
 - Analysts agreed that few sectors would be unaffected by global financial shocks, which can be highly contagious across not only sectors but globally, as evidenced by the US sub-prime mortgage crisis.
- The fragility of financial sector growth sustainability from excessive leveraging could lead to a dramatic fallout.
 - Securitization of financial risks has resulted in wide disbursement of risk. In theory dispersion should work, but the opposite has happened, partly because of complexity of financial instruments, off balance sheet vehicles etc.
- Financial innovation – while it disperses risks it makes the detection of potential financial shocks more difficult.
- As a company do you clearly understand and have evaluated the impact of how the recent market downturn and global financial shocks will impact your current operating strategy?



3. Aging Consumers and Workforce

- Average age of workforce is increasing; people working longer and have greater expectations with respect to post retirement benefits, including but not limited to pension and health care benefits
- Competitive battles over products for older consumers
- Significant human resource challenges
 - Retention of employees in certain industries and markets
 - Younger employees looking for better work life balance
- Businesses in sectors enjoying growth from the increase in the average age must effectively respond to the demographic shift to keep their competitive edge



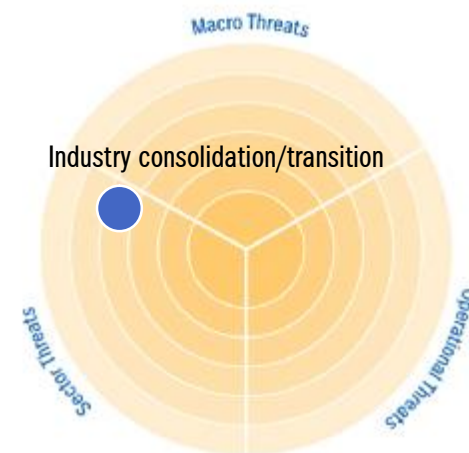
4. Emerging Markets

- Increase in the world's population will come from developing countries.
 - Companies in developed markets will need to enter into these regions to expansion, not only because of the increase in consumers, but also because existing markets will reach maturity and saturation in the developed world.
 - Emerging Middle Eastern markets moving from oil and gas to tourism and real estate creating increased competition
 - Emerging markets partnering with global companies
- Failure to exploit emerging markets could undermine competitive standings. For example global media companies revenues limited to 5% of their total revenues in emerging markets
- Only 41% of developed market countries have a risk strategy for emerging markets; more than half (56%) have no strategy
- Emerging markets offer supply chain advantages; i.e. cheaper labor, fuel etc. Focused on collaboration, infrastructure investments, new technologies etc.
- Traditional risks such as currency, language and cultural divides remain; global businesses must now be aware of increased competition, managing outsourced business and supply chains in emerging markets.



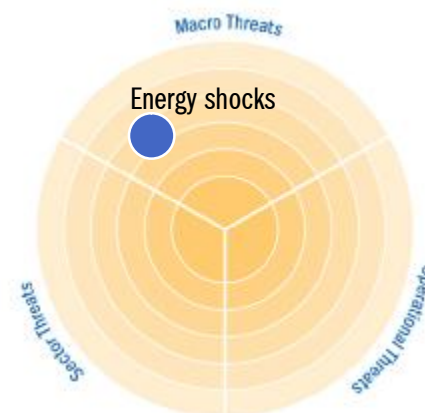
5. Industry Consolidation/Transition

- Consolidation, restructuring and spin-offs are anticipated
- There will be a global misalignment in the location of industry capacity and location of demand (e.g. automobile manufacturing in the US, while demand is in China).
- Size is important as it provides some protection against hostile acquisition. The need to grow to stay competitive, if not met by organic growth, may need to be met by acquisitions.



6. Energy Shocks

- Few companies are immune to this risk.
 - Loss of access to competitively priced long term fuel supplies is a strategic risk impacting all industry sectors
 - What has been the impact to your company as a result of higher oil/fuel costs as an example? e.g. Increased transportation costs has increased cost of consumer products
- Fluctuations in energy prices and available supply of electricity and water are creating further energy shocks
- Political responses to energy security, through reactions to any potential crises in securing supply, may cause markets to panic, forcing governments to respond with even more unilateral steps, making the situation much worse for all.



7. Execution of Strategic Transactions

- Transactions pose a risk because of operational challenges dealing with integration of people, process and technologies of combined entities
- New types of strategic transactions are taking off. No longer are transactions just about growing the bottom line, but they now include acquiring talent or intellectual property that can't be home-grown.
- The excellent execution of small and highly strategic transactions may have as great a competitive impact as the big mergers
- While a transaction may move to quickly capitalise on an opportunity, this may turn into an expensive, long-term risk in its own right if thorough research is not undertaken.



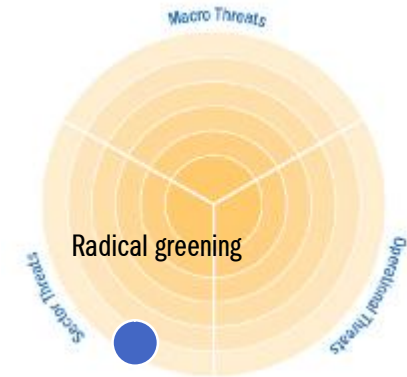
8. Cost Inflation

- Inflation is a significant operational threat for all sectors
 - After enjoying a low inflation economy for some time, the return of high inflation across the globe is a major risk.
- In many sectors, cost pressure is driven by changes to industry structure
 - Demographic changes and the rising costs of health care for U.S. auto manufacturers
 - Regulation, expensive clinical trials, and higher costs to develop drugs for biotech
 - Mega-retailers and discounters has resulted in greater control over prices
 - Volatility of raw materials prices for consumer products makes management of input prices a challenge
 - Business models focusing on cost for other sectors



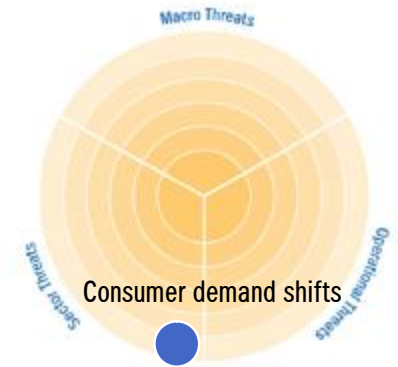
9. Radical Greening

- Increasing environmental concerns
 - Zero tolerance for environmental accidents
 - Increased pressure for corporate social responsibility
 - Increased regulation
 - Control over carbon emissions
 - Unexplained climate changes
 - Popularity of topic by politicians
- Consumer and regulatory responses to climate change and weather events
- How much radical greening should firms undertake?
- Some firms will get the it right, while others will go either too radically green or not green enough
 - Recent Winnipeg example of circulation of plastic containers as part of marketing strategy
 - The key is to finding the right combination in fuel mix, real estate portfolios, or carbon footprints, which are neither too radical nor too conservative.



10. Consumer Demand Shifts

- Identifying and responding to changes in demand becomes a strategic risk when the changes are significant, fast, or unexpected.
- Failure to anticipate and respond to consumer demand shifts:
 - Green products and services
 - Needs of aging consumers
- Consumer empowerment has shifted greatly over the past 10 years, pushing content and distribution channels to change, often forcing many old production philosophies to become antiquated.
 - Increased demand for customization rather than mass production. Can create opportunities. E.g. Option pricing in automotive industry



Below the Radar – The Next Five

- Our study identified concern for five other significant strategic risks:
 - War for Talent
 - Pandemic
 - Private Equity's Rise
 - Inability to Innovate
 - China Setback

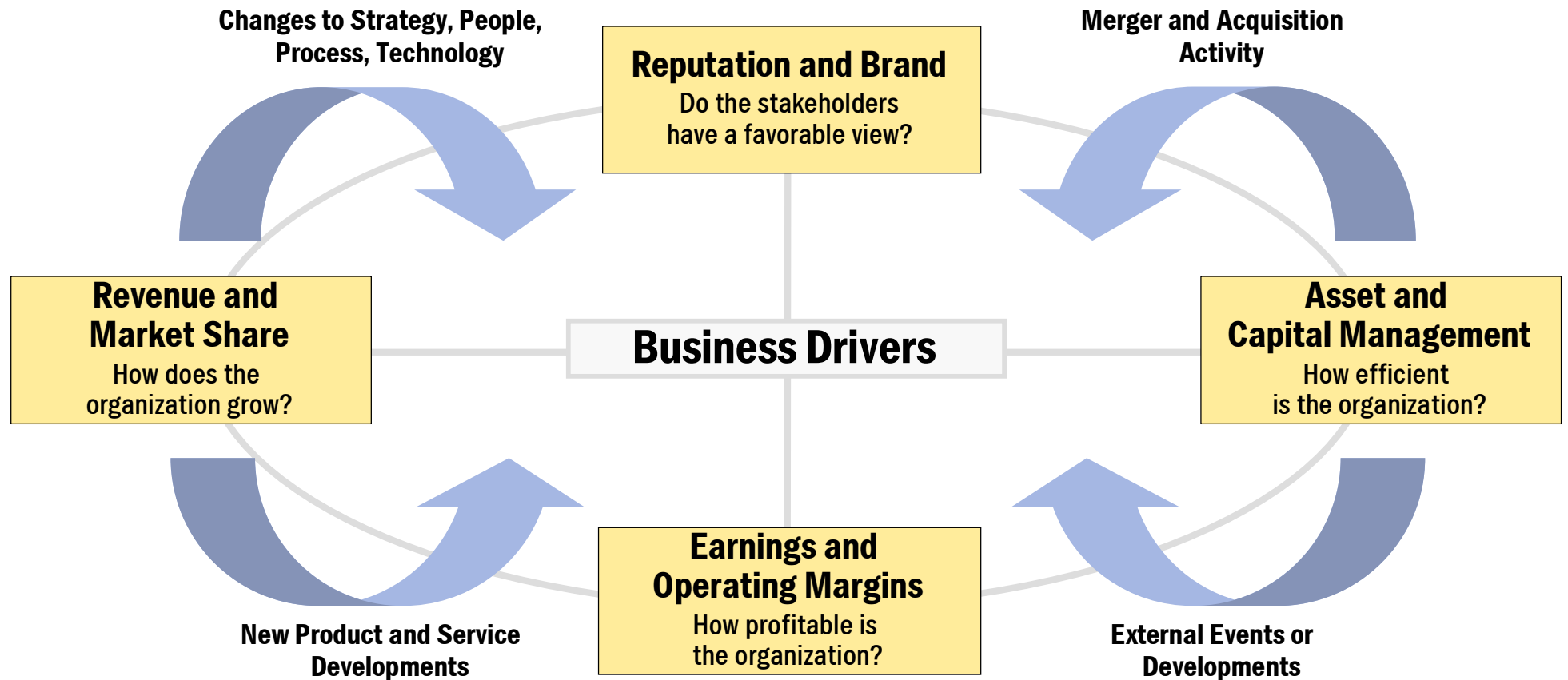
Implications for Management

- This research is a snapshot of the key strategic risks facing businesses
- It should help you begin or amplify a dialogue within your organization
- Management and board members must take ownership for identifying strategic risks and reviewing the overall risk management and control infrastructure
- Leading organizations understand their strategic risks and how these risks could affect key business drivers and objectives
- Analysts and investors expect organizations to assess and monitor their key risks and provide transparency into how those risks are managed
- A coordinated process for managing and monitoring risks can lead to performance improvements and competitive advantage

Management Actions

- Is your risk radar current?
- Conduct an annual risk assessment that defines key risks and weights probability and impact on business drivers
- Extend the risk assessment beyond financial and regulatory risk to consider the wider environment in which your organization operates and the full extent of its operations
- Conduct scenario planning for the major risks that you identify and develop a number of operational responses
- Evaluate your organization's ability to manage the risks that you identify – in particular ensure that your risk management processes are linked to the risks that your business actually faces
- Ensure you have effective monitoring and controls processes that can give you both earlier warning and improved ability to respond
- Keep an open mind about where risks can come from.
 - In an increasingly interdependent global economy, risks that can damage your business can initiate in markets and sectors a long way from your own

Define Your Risk Radar



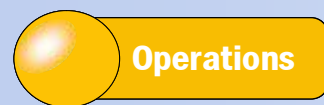
Define Key Enterprise Risks

Risk assessment efforts should focus on the issues with the greatest potential to impact objectives

Risk Universe Categories TM



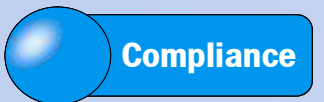
- Planning and Resource Allocation
- Major Initiatives
- Mergers, Acquisition and Divestures
- Market Dynamics
- Communication and Investor Relations



- Sales & Marketing
- Supply Chain
- People
- Information Technology
- Hazards
- Physical Assets



- Market
- Liquidity and Credit
- Accounting and Reporting
- Tax
- Capital Structure



- Governance
- Code of Conduct
- Legal
- Regulatory

Key Considerations for Management

What are our key risks?

Are we focused on the risks that matter?

Who is accountable for the key risks?

Are resources aligned to our risk profile?

Are we accepting an appropriate level of risk?

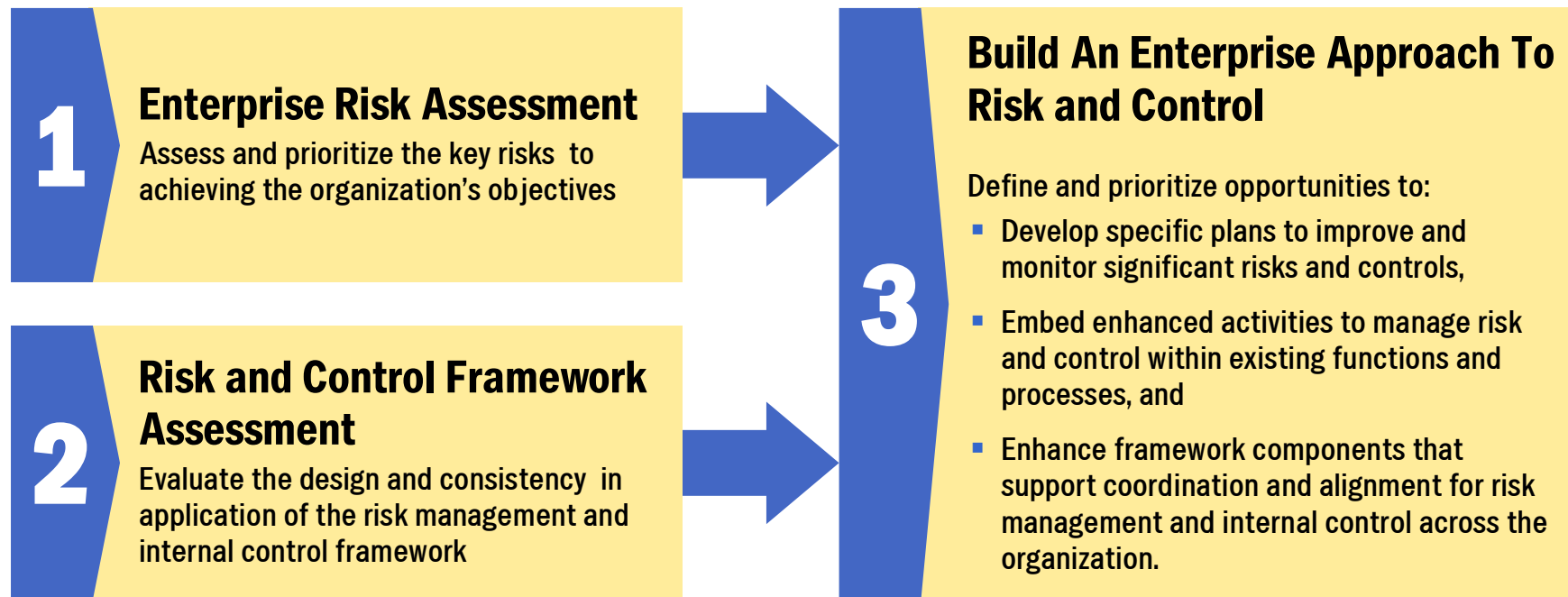
Are we receiving a fair return on that risk?

Who is monitoring the significant risks?

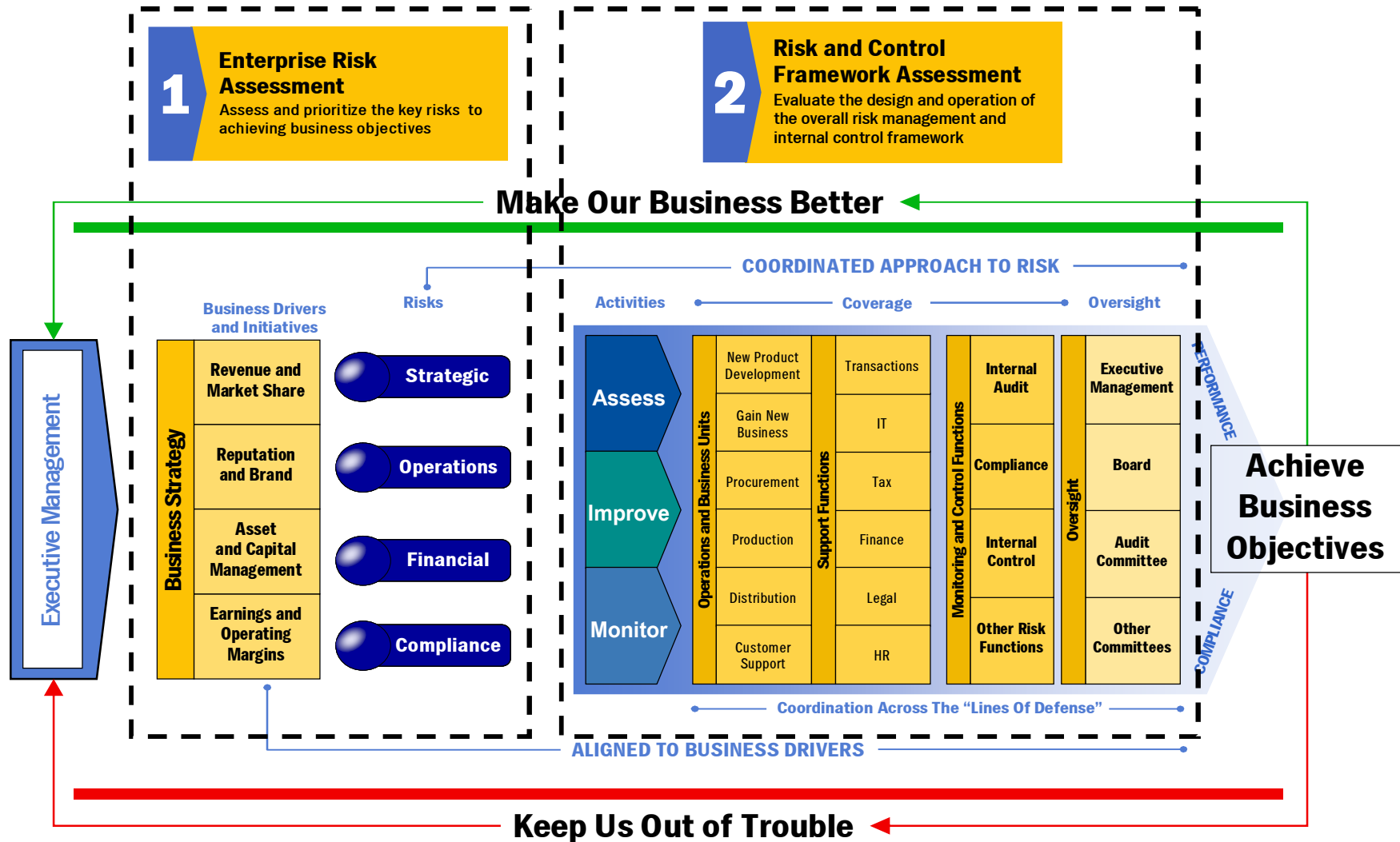
How are we improving key controls?

A Practical Approach...

Ernst & Young recommends performing an enterprise risk assessment and then reviewing the risk management and internal control framework to determine the areas where incremental improvements would provide greater benefit to the business.



Enabling An Enterprise Approach To Risk and Control



Other Ernst & Young Global Risk Surveys

- An ongoing program exploring attitudes toward risk and risk management
 - Investors on Risk: The Need for Transparency – Large institutional investors
 - Companies on Risk: The Benefits of Alignment – Finance and Business executive managers
 - Board Members on Risk: Leveraging Frameworks for the Future – Audit Committee and Board members
 - Tax Risk: External Change, Internal Challenge – Tax directors
 - Managing Risk: Cross Stakeholder Report – Composite results for all stakeholders
 - Internal Controls: From Compliance to Competitive Advantage - Non-SEC company approach to Internal Controls
 - Risk Management in Emerging Markets – Management practices in emerging and developed markets

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