The Board and Risk Oversight: Increasing Transparency Through Proxy Disclosure

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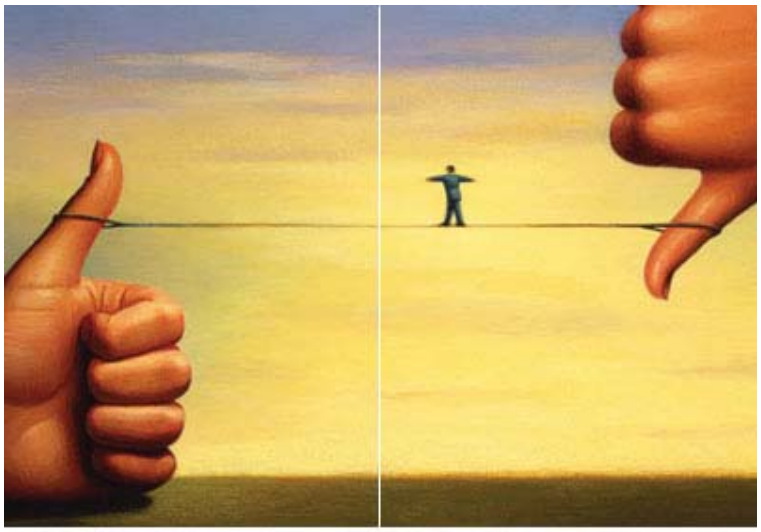
While risk oversight has always been an important board function, a number of questions have arisen since the Securities and Exchange Commission (SEC) issued the enhanced proxy disclosure rules in December 2009. Who owns risk oversight? Is it a full-board responsibility or the domain of the audit committee? Is there a "correct" level of risk? How has the oversight of risk been altered by heightened shareholder scrutiny?



[1]The rules, designed to provide greater insight into a number of governance areas, including disclosures about the role of the board in risk oversight, applied to public companies with fiscal years ending on or after December 20, 2009 and which filed their definitive proxies on or after February 28, 2010. At that time, the SEC declared that risk oversight is a key responsibility of boards and that additional disclosure would improve shareholders' understanding of boards' roles in risk-related practices. The enhanced proxy disclosure rules require companies to explain how the board administers its risk oversight function, whether the entire board is involved in risk oversight or delegates the responsibility to a board committee and how employees responsible for risk management report to the board.

During the 2010 proxy season, Deloitte analyzed the relevant risk-related disclosures of the companies included in the S&P 500. The results provide a profile of risk disclosures across key industry segments, insight into board risk-oversight practices and indicate ways in which boards and board-level committees can further enhance disclosures to increase transparency.

Key Findings

Deloitte analyzed the risk disclosures of 398 companies in the S&P 500 subject to the SEC's amended rule (*see sidebar on Methodology, at bottom of page*). Deloitte's analysis focused on 20 criteria relating to the principles and practices of Deloitte's Risk Intelligent Enterprise, which details leading practices for boards and executive teams pursuing excellence in risk oversight and risk management.

"While risk management is also top-of-mind for legislators and regulators, the challenge is to develop a program that is practical while, at the same time, addresses the critical or 'value-killer' risks of an enterprise and one that hinges on the board and executive management to sponsor this program. Our study intended to identify the basic elements of such a program," notes Henry Ristuccia, partner, Deloitte & Touche LLP and U.S. leader of governance and risk management services.

In its analysis, Deloitte found that:

- Most disclosures (90 percent) noted who is responsible for risk management and almost as many (80 percent) noted that those responsible report directly to the board.

- More than half of the disclosures (58 percent) noted that the audit committee is the primary committee responsible for risk.

- More than half (53 percent) of the respondents noted that the compensation committee is responsible for overseeing risk in the organization's compensation plans.

A number of risk oversight practices were less in evidence or not mentioned. A minority of companies noted other key practices related to the board's risk oversight:

- One-third (34 percent) of the disclosures noted whether risk oversight/management are aligned with the company's strategy.

- About one-fifth (22 percent) of disclosures noted whether the Chief Executive Officer (CEO) is responsible for risk management or how the CEO is involved in risk management.

- About one-fifth (19 percent) noted that the company has a risk management committee at the management level, but only 4 percent noted the presence of a board-level risk committee.

- Only 11 percent of disclosures noted the board's involvement in determining the company's risk appetite.

How Directors View Risk

Have the new disclosure rules prompted changes in how boards assess their risk oversight? A number of executives weighed in:

"Without risk, you have no business," says Curtis Crawford, PhD, who serves on multiple public-company boards. "There is a connection between risk and reward and [as a board] you should have enough data points to understand the risk and then determine, based on your knowledge and experience, whether the risk is worth it." Crawford, founder, president and CEO of XCEO, Inc., was elected to his first public company board 16 years ago; he feels today there is more risk associated with not taking risks and—concurrently—a steep downside for directors who now have a higher profile with investors and shareholders. "More disclosure and transparency raises the level of risk for the individual director," Crawford asserts, especially in the litigious environment in which business now operates. "Disclosure doesn't determine how I operate in the boardroom, but I am sensitive to the higher profile that directors have. I think it's important for investors to understand the difference between risk oversight and risk management. They are not interchangeable. The board is not in the risk management business. The SEC has been quite articulate that the board's role is not to manage, but to oversee risk."

One concern that James T. Brady—who chairs the audit committee at Constellation Energy, T. Rowe Price and McCormick Corp.—has about the spate of expanded disclosure requirements relates to the growing complexity of proxy statements. "For a person of normal intelligence, proxy statements are rapidly approaching incomprehensibility," he says. "There is always a residual risk that excessive transparency will morph into opacity."

Despite this concern, Brady believes the focus on risk, which has reached a crescendo over the last three years, "is appropriate and long overdue." While risk has always been on directors' radar screens, he says, "the intensity and focus has never been greater" not because of disclosure rules, but rather as a result of the volatile business environment.

Risk tolerance, Brady suggests, is the inevitable result of the critical marriage between strategic objectives and risk assessment. "How we balance the risk-reward trade-off appropriately is the key. As directors, we don't spend time overseeing risk management because we have new disclosure rules. We do it because that's our job."

While all directors acknowledge the importance of the proxy statement, Debra Perry sees the proxy as the most important medium for communicating with shareholders and investors, particularly on the critically important topic of risk oversight. "Boards need to take a different view of the proxy," Perry says. In view of the necessity of shareholder engagement, boards should look at the proxy as "a communications document, not just a compliance document." Prior to her retirement in 2004, Perry was senior executive at Moody's Corp.; since then, she has served on three public company boards

and currently serves on the board of Korn/Ferry International. Her perspective on risk oversight during the period in which she has served on boards is that it is has evolved from a discreet topic at board meetings to a full-fledged discipline that is frequently distributed among several board committees.

"It's encouraging to see that boards and executives in corporate America are not taking a 'one-size-fits all' approach to disclosing risk information," says Maureen Errity, director, Deloitte LLP Center for Corporate Governance. "But the more companies can share the full story in their proxy disclosures, with regard to what risk governance structures boards have in place to oversee risks as well as the risk management infrastructure utilized to execute the program, the more risk intelligent corporate America-—and its investors—will become."

Detailing the New Disclosures

The following sections detail the findings by individual criteria. For each criteria consideration, the percentage garnering a "yes" is presented for the whole sample and for each industry segment. Actual language culled from selected proxy statements is featured in sidebars. Deloitte grouped the 398 S&P 500 companies included in the analysis population into five industry classifications: financial services (FS); technology, media & telecommunications (TM&T); consumer & industrial products (C&IP); health sciences & government (HS&G); and energy & resources (E&R).

1. Does the disclosure note that the full board is responsible for risk?

S&P 500	FS	TM&T	C&IP	HS&G	E&R
86%	79%	85%	90%	86%	87%

[2]

Boards are responsible for risk oversight or for exercising oversight responsibility through board-level committees. Ultimately, the full board should discuss the risks that are most material and to which the company is most vulnerable, since they can have the most potential impact on the organization. For this consideration, the analysis revealed a mix of companies noting that the full board is responsible or delegates ownership to certain committees of the board. Either way, the board recognizes the ultimate responsibility.

Crawford, who chairs the science and technology committee for DuPont and also serves on the boards of ITT and ON Semiconductor, says disclosure requirements have broadened the discussion around risk in general, and heightened scrutiny by shareholders, legislators and regulators as a result of the global downturn and numerous high-profile risk management failures in the financial services industry. He has been vocal that risk oversight is a full board responsibility. Noting that the typical audit committee meets longer and more frequently than other board committees, "The board owns overall risk oversight…What we're doing as a full board is assigning risk over to the committees for various parts of the risk portfolio," he says.

2. Is the audit committee noted as the primary committee responsible for risk?

S&P 500	FS	TM&T	C&IP	HS&G	E&R
58%	53%	52%	64%	60%	59%

[3]

Given the New York Stock Exchange listing standard requirements and the audit committee being responsible for major financial risk exposures, historically, many audit committees were tasked with the responsibility of overseeing the full risk management program. However, in this new environment, risk management is being highlighted as central to good business practices and many boards are reevaluating committees' involvement in risk oversight. Some companies are assigning the oversight

of certain risks to the committee with the appropriate expertise; many still identify the audit committee as having primary responsibility for risk oversight.

3. Are other board committees noted as being involved in risk oversight?

S&P 500	FS	TM&T	C&IP	HS&G	E&R
82%	78%	82%	83%	83%	84%

[4]

With the audit committee taking primary responsibility, many boards are revisiting committees' roles and delegating oversight of certain risks to other board committees. Such reallocation of responsibility is based on whether the committee members have the expertise to oversee certain risks. For example, compensation committees may be responsible for compensation and human capital risks, and the governance/nominating committee may address legal risks, if there is a lawyer on such a committee.

In addition to the three standing committees noted, more than 80 percent of the companies cited the involvement of other board committees in risk oversight, including oversight and public policy, people resources, innovation and technology and mergers and acquisitions.

Risk related to pay is often assigned to the compensation committee, risk associated with balance sheets is assigned to the audit committee, compliance risks are given to the corporate governance committee, and so on. At ON Semiconductor, where he chairs the corporate governance and nominating committee, Crawford explains, "The committee's responsibility is to be a steward and to bring it back to the board to keep us current. Some aspect of risk is discussed at every board meeting and formally at the end of each year, the board reviews the risk assignments and the quality of the committee's stewardship."

While only 36 companies in the analysis actually used the word "primary" for the audit committee's responsibility, the consideration rendered a positive response when the audit committee was noted as having responsibility for overseeing the risk management program or the policies and processes for risk assessment and ultimate management. Further, some companies have now combined the audit committee with other committees such as the
finance committee or ethics committee, but only six companies disclosed that their audit committee is named the audit and risk, risk management or risk policy committee. In such instances where committees were combined, the same standard applied to the yes/no responses as previously noted.

4. Is the compensation committee disclosed as being responsible for overseeing risk in the compensation plans?

S&P 500	FS	TM&T	C&IP	HS&G	E&R
53%	52%	60%	53%	45%	54%

[5]

The new disclosure rules require that companies analyze compensation practices and disclose when risks arising from them are likely to have a material adverse effect. The compensation committee should play a role in overseeing that analysis and understand how the results are disclosed. Companies should consider disclosing the involvement by the compensation committee in this process within the board's role in the risk oversight section of the proxy. Similar to findings about the role of the audit committee, the analysis revealed that some companies have combined the compensation committee with other committees or renamed the compensation committee to include other responsibilities. Some examples of the committee names noted include: the compensation and management development committee; the compensation and human resources committee; the

compensation and organization committee; and compensation and leadership development committee.

Regardless of the committee name, in today's environment, compensation is still the issue that generates the most discussion among directors. "That is the issue," notes Brady. "Compensation is the most challenging issue on each of my boards because of the critical need to achieve answers that are fundamentally fair to both our executives and shareholders. At the same time, we have to be cognizant of the need to ensure that our disclosures in proxy statements do not compromise our company from a competitive standpoint and are not unduly subject to misinterpretation. I do worry that the currently required tables in proxy statements do run the risk of being grossly misconstrued and misused."

5. Does the company have a separate board risk committee?

S&P 500	FS	TM&T	C&IP	HS&G	E&R
4%	16%	1%	1%	0%	1%

[6]

This consideration yielded a significant difference in responses within the financial services sector. Some of the large-cap financial institutions had and continue to utilize board risk committees to oversee and monitor credit, market and liquidity risks, and types of risks most unique to the financial sector. The recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act will require a separate risk committee for certain financial institutions; it's likely that the percentage within the financial services sector will increase going forward.

Even if there is a board committee for risk, the board should determine whether and how other board committees should be involved with risk oversight. As noted in an earlier consideration, risk oversight is most effective when committees with expertise in certain risk categories oversee the respective risk. Therefore, establishing a separate risk committee should not imply that risk oversight is "siloed" to that committee.

6. Does the disclosure note how often the board discusses risk oversight?

S&P 500	FS	TM&T	C&IP	HS&G	E&R
84%	79%	82%	84%	90%	86%

[7]

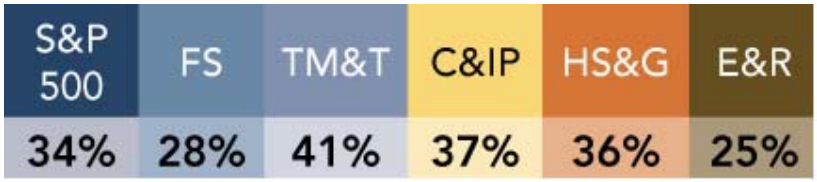
Board members should address risk oversight at the committee level more frequently than at the board level. However, the full board should place risk oversight on the agenda at least annually, if not more frequently, including a discussion of the risks where the company may be most vulnerable and could have the most significant impact. In addition, boards overseeing risk should have appropriate transparency and visibility into the organization's risk management practices. While some disclosures were not as detailed with regard to frequency, a positive response was rendered within Deloitte's analysis as long as companies discussed timing using terms such as: periodically, routinely, regularly or more specifically such as daily, weekly, yearly and annually. Companies may consider providing more detailed information on timing—whether annually or at every meeting—in this way, shareholders can better assess the significance of risk discussions.

Lowell Robinson, a leading public company board director who has chaired three audit committees, says that since his board service has not included financial services companies; the audit committee typically has primary responsibility for risk oversight.

"The audit committee reviews a risk-management matrix at each meeting and briefs the board on

significant changes. All decisions are assessed and evaluated from a risk-return perspective," Robinson says.

7. Does the company disclose whether risk oversight / management are aligned with the company's strategy?



[8]

Conventional risk management focuses on avoiding the risks to a business strategy, rather than understanding the risks of the strategy itself. While the former may protect current assets, it usually will not create a competitive advantage. Challenging and approving the company's business strategy is a primary role of the board. In this context, the board should work with management to move toward a broad, positive "portfolio" view that considers strategic risk-taking for reward as well as asset preservation.

Robinson says on the boards he has served, typically the risk assessment process is aligned with the strategic plan. "We understand the company's goals and objectives and then begin to develop information from the 10-Ks of the company's competitors. Interviews are then conducted with senior management, the audit committee and others to assess key risks——these usually number 35 and are assessed in terms of their impact on financials, shareholders and lenders, as well as customers. We then assess them in terms of vulnerability with respect to control effectiveness, complexity of operations, rate of change and prior risk experience. We then take the top twenty risks and identify the key auditable risks and then develop a risk-based audit plan for the year."

8. Does the disclosure note whether the CEO is responsible for risk management or how the CEO is involved?

[9]

As the ultimate risk manager and owner in the enterprise, the CEO is responsible for making risk management a priority and for defining related roles and responsibilities. Given the board's and CEO's primary roles in, respectively, overseeing and managing risk, they must collaborate constructively on risk-related matters. Further, when the CEO has ultimate ownership of risk, the tone is set throughout the organization that thinking and discussion about risk is a priority for the organization.

9. Does the disclosure note who is responsible for risk management in the organization?

[10]

Although the CEO should be responsible for risk management, the analysis revealed that in some

companies the responsibility is delegated to a specific executive or to a management committee, or the most represented delegation was to the more general "management." Leaders should consider which management structure would best suit the organization, depending on factors such as size, industry and degree of decentralization. Senior management's involvement helps risk management attain the stature it warrants in the organization.

10. Do employees that are responsible for risk management report/present directly to the board?

[11]

Individuals or committees responsible for risk management should report or present directly to the board on a regular basis. This approach will assist the board in fulfilling its responsibility with regard to risk oversight. Reports to the full board should occur at least annually, with more frequent reports to the board committees.

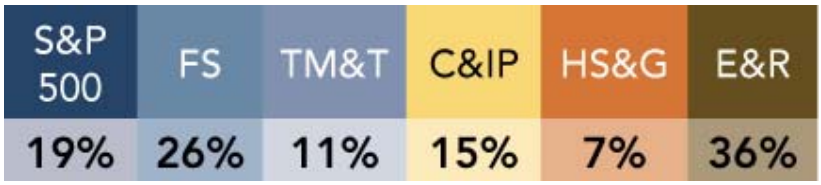
11. Does the company have a Chief Risk Officer (CRO)?

[12]

Many organizations are working to enhance their risk management structure, and while there is no "one size fits all" to risk management, some companies are considering engaging a CRO or perhaps establishing a more formalized risk-management committee structure. Few of the S&P 500 companies have a CRO. The position is more prevalent in the financial services and energy and resources sectors. The CRO is typically responsible for managing risk, ensuring that the risk identification, assessment and monitoring processes and procedures are occurring appropriately. When someone other than the CEO has been designated as CRO, he or she should report directly to the CEO—perhaps with a dotted reporting line to the board risk committee, other committees overseeing risk or the full board.

Many experts feel that it's imperative that companies—particularly those in the financial services sector—have corporate risk officers. Perry says one element that stood out in the Deloitte study was how few financial services firms have chief risk officers. "That surprised me," she says. "Managing risk requires horizontal and vertical views of both the company and the markets in which it operates and having that chief risk officer position to pull it all together is really useful."

12. Does the company have a risk management committee (at the management level)?



[13]

Similar to the creation of the CRO position, a risk management structure is evolving to enable senior executives and business unit managers to discuss identified risks in the context of a risk management committee. Such a committee brings together the various business units and operations leaders to allow for an enterprise-wide level discussion of risks; it can also help set risk tolerances and,

ultimately, the enterprise's risk appetite. Risk management committees typically meet quarterly or even more frequently and the individual ultimately responsible for risk management (CEO, CRO, CFO, etc.) will drive the agenda and lead the conversation. Not unlike the CRO position, risk management committees are most often found in the energy and resources, as well as the financial services sectors.

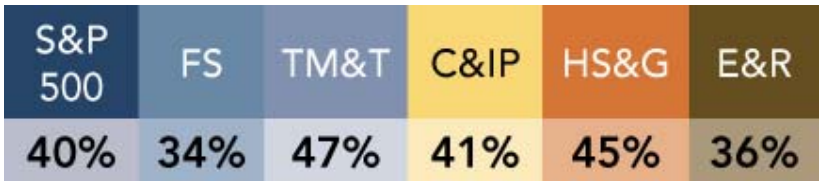
13. Does the disclosure note how the board is involved with regard to the company's risk appetite?

[14]

Risk appetite defines the level of enterprise-wide risk that leaders are willing to take in pursuit of strategies, including acquisitions, new products and market expansion. Risk appetite is best expressed as a monetary figure or as a percentage of revenue, capital or other financial measure. However, less quantifiable risks, such as reputational risk, should also be considered in setting risk appetite. It's also important to distinguish between risk appetite at the enterprise level and risk tolerance at the business-unit level. Failure to do so can lead to risk tolerances that do not reflect the overall risk appetite or that amount to general statements of risk appetite that give decision-makers too little guidance. The terminology may not be as important as the fact that companies are making a link between strategic direction and the ultimate threshold of risk that management (and the board) is willing to accept.

In the analysis of the companies surveyed in the S&P 500, only 18 used the evolving term of "risk appetite," while 17 companies mentioned "risk levels" and another 17 companies discussed "appropriate and acceptable risk taking."

14. Does the disclosure separately address strategic risk?



[15]

This consideration, and the next four considerations, focuses on whether the disclosure noted specific risks, because identifying specific enterprise-wide risks is a significant part of risk management. Many companies categorize risks into four main risk types—strategic, operational, financial and compliance—with a fifth, reputational risk, potentially crossing all four categories.

15. Does the disclosure separately address operational risk?

[16]

16. Does the disclosure separately address financial risk?

S&P 500	FS	TM&T	C&IP	HS&G	E&R
53%	43%	58%	52%	62%	57%

[17]

17. Does the disclosure separately address compliance risk?

S&P 500	FS	TM&T	C&IP	HS&G	E&R
41%	44%	34%	39%	55%	41%

[18]

18. Does the disclosure separately address reputational risk?

S&P 500	FS	TM&T	C&IP	HS&G	E&R
17%	30%	11%	12%	26%	12%

[19]

19. Does the disclosure note the board's oversight with regard to corporate culture?

S&P 500	FS	TM&T	C&IP	HS&G	E&R
5%	10%	3%	4%	5%	6%

[20]

As Deloitte defines it, a Risk Intelligent Enterprise establishes a culture in which risk management is embedded in policies and procedures at all levels and all employees consider risk in the performance of their jobs. The board can play a role in developing such a culture by working with management to encourage open communication—and appropriate escalation of reporting—of risks throughout the enterprise. Surprisingly, only a small number of companies have elevated the discussion of risk to ensure it is embedded into the culture. However, with the continued focus on this topic, it is expected that such cultural changes (and the related disclosures) may occur. While the percentages are lower than expected, it is not surprising, however, that the financial services industry is leading the way with this practice as many of its activities are central to risk management.

20. Does the disclosure note the significance of tone at the top?

S&P 500	FS	TM&T	C&IP	HS&G	E&R
1%	1%	0%	2%	0%	1%

[21]

The board plays a significant role in setting expectations regarding risk oversight and management in the enterprise. The board helps to set the tone by advising and challenging management regarding risks and risk management, and identification, assessment, monitoring and communication about risks. The board can also generate transparency in its communications and disclosures to internal and external stakeholders.

Looking Ahead

This was the first year in which the SEC enhanced proxy disclosure rules regarding risk disclosures were in effect. The levels and types of disclosures can be expected to change as more companies adopt the new requirements and receive feedback from investors on their proxies. Overall, the revelations follow a trend that one might expect. That is, most companies across industry segments disclosed the most widely accepted practices, including: full board responsibility for risk; board committees having risk oversight responsibilities; risk related discussions are occurring; and, those responsible for risk are reporting/presenting to the board. Indeed, those practices, which essentially assign responsibility for risk and define the risk oversight and risk management infrastructure, are generally precursors to other risk oversight and management practices.

By the same token, practices that one would associate with more "advanced" risk oversight were disclosed less frequently, such as CEO involvement in the risk management process, alignment of risk oversight/management with strategy and the board's role in setting the tone for making risk management a priority in the corporate culture. Risk related disclosures—and risk oversight and management practices—will continue to evolve to meet market needs and regulatory demands.

Deloitte's Ristuccia and Errity both agree that companies should continue to focus on developing a risk culture founded on risk-taking to not only protect the current assets but as a step toward creating value. Says Ristuccia: "Leading companies may benefit from using the 2011 proxy disclosures as a way to offer even more visibility and transparency into such transformations."

Methodology

During the 2010 proxy season, Deloitte analyzed the proxy statements (source: SEC EDGAR platform) of 398 S&P 500 companies that were subject to the SEC's amended rules on board-level risk oversight—those with fiscal years ending on or after December 20, 2009 and which filed proxies on or after February 28, 2010. Deloitte limited its analysis to the information included within the "board's role in risk oversight" (or similar) section or paragraphs of the proxy statement. If the statement did not include such a section, the "board leadership" or "board structure" paragraphs were used. There were 21 companies among the 398 that were analyzed which did not include either of these paragraphs. To facilitate the analysis of approximately 400 proxy statements and to generate useful, comparable data, Deloitte developed 20 considerations that could be answered "yes" or "no" by the reviewers. This brought objectivity to the analysis, minimized interpretation and focused on what the companies actually reported. These particular criteria were developed by Deloitte based on risk practices that reflect approaches, which characterize the Risk Intelligent Enterprise. A Risk Intelligent Enterprise approach recognizes the need for an integrated risk management program that embeds capabilities throughout all levels of the organization.

As used in this article, Deloitte refers to Deloitte LLP, Deloitte & Touche LLP, Deloitte Consulting LLP, Deloitte Tax LLP and Deloitte Financial Advisory Services LLP.

Deloitte accepted the risk disclosures at face value. Deloitte did not develop—and is not providing—any opinion regarding companies' practices or interpretation of the SEC's amended rule. Rather, Deloitte utilized the risk disclosures as a source for information about what risk-related practices companies are employing. The goal was to understand each company's board-level risk oversight practices as reported to shareholders and prospective investors.

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