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Risk resilience
Reckoning with a new era of threats

Private companies are rethinking their approach to risk against a backdrop of globalization, economic realignment, and rapid technological change.

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is published by PwC's Private Company Services (PCS) practice. Here we discuss the challenges privately owned businesses face and where the opportunities lie, suggesting how you can effectively make the most of both.

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Risk resilience: Reckoning with a new era of threats

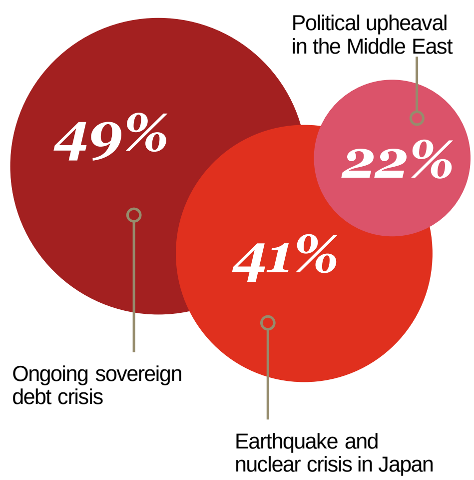
Globalization, economic realignment, and rapid technological change are likely to drive volatility for years to come. Against this backdrop, private companies – both domestic and global – need to rethink their approach to risk so that shocks to the system won't derail corporate strategy and undermine growth.

Companies that pursue growth must take on risk. There's nothing new in that. Rather, what's different from decades past is the complexity and proximity of the risk landscape in what has become an increasingly interconnected world. Black Swan events[1] and other external shocks that might be geographically far from home – the Japanese tsunami, Arab Spring, and Eurozone crisis, to name a few – are having swifter and greater effects on US businesses than in previous eras. Over the past couple of years, the sheer volume of such events has caught many private companies off guard, highlighting blind spots in their approach to risk resiliency.

"Without a doubt, Black Swan events are exposing vulnerabilities in US private companies," says Karen Vitale, a partner in PwC's Private Company Services practice. "These events drive home the realization that no matter where they operate, US businesses are not insulated from major disruptions elsewhere in the world."

That's true even if your business sells, manufactures, and sources exclusively in the United States. "Bear in mind that what affects your suppliers' suppliers is apt to affect you as well," emphasizes Vitale. "Likewise, what affects your customers' customers will affect you. Chances are those various suppliers and customers are not all sitting in just one part of the world."

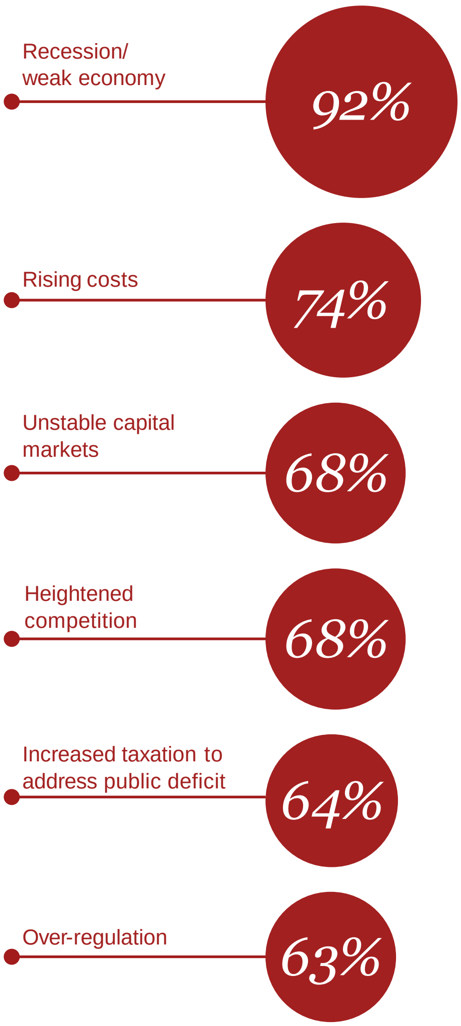
Global events having a direct financial effect on US private companies:



Percentages reflect the US private companies affected by these events.
Source: *15th Annual Global CEO Survey*, PwC, 2012

1. This article uses the term "Black Swan events" to denote low-probability, high-impact events.

Top risks cited by US private companies



Source: *Trendsetter Barometer*, PwC, 2012

In short, private companies operate in a global marketplace by default nowadays. That reality is underscored by the top four risks flagged by privately held businesses in a recent PwC survey: (1) recession/weak economy, (2) rising costs (including the cost of oil and other commodities), (3) unstable capital markets, and (4) heightened competition (including competition from foreign businesses looking for greater market share in the United States). All four of those risks are impacted by the global arena.

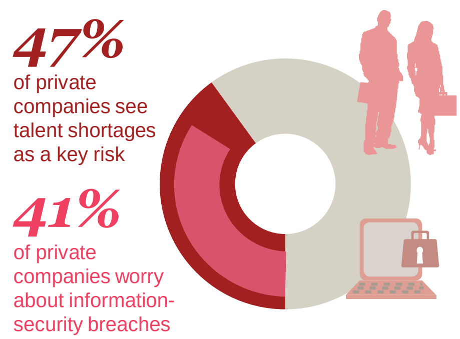
The private companies we surveyed also voiced concern about internal risks, including risks around talent and technology – two areas that underpin innovation, making them key to business growth. Indeed, 75% of private companies are making innovation a priority.[2] Almost the same percentage (74%) plan an immediate increase in their technology spending.[3] But for these investments to pay off, companies need workers skilled in running new technology and harnessing it for innovation. Such workers are in short supply these days, hampering private-company growth.[4]

And, of course, with new technology there often comes a host of security concerns, which private companies are alert to but not necessarily sure how best to handle.[5] While they may want, for instance, to adopt cloud computing so that they can cut costs and quickly launch new growth initiatives, they may also be leery of the risks posed by the cloud.

The challenge is to deal with these evolving risks while still keeping a laser focus on driving innovation and increasing value. The businesses tackling that challenge best are modifying their old approaches to risk. They're also adopting entirely new ones, such as risk strategies that focus more on the *consequences* of a wide range of potential risk events and less on the *probability* that those events will occur (for more on this approach, see page 5).

For some businesses, making no change whatsoever to how their company handles risk may pose the biggest risk of all. "Companies should look hard at the risk-management approach they have in place now and decide whether it can take them where they need to go tomorrow," stresses Vitale. "That may require a mindset change for some companies. It means viewing risk management more as a business enabler – one that helps propel the organization forward – and less as a rigid structure shielding the company."

Other key risks flagged by private companies



Source: *Trendsetter Barometer*, PwC, 2012

2 "Innovation Imperative: Keeping Your Company Relevant," *Growing Your Business*, PwC, 2012
3 *15th Annual Global CEO Survey*, PwC, 2012
4 "Talent Riddle: Where Are the Workers Who Will Power Growth?" *Growing Your Business*, PwC, 2012
5 "Cyber Security: Why You Can't Afford to Ignore it," *Growing Your Business*, PwC, 2012

Hand in glove

Integrating risk strategy with growth strategy

Turning risk management into a business enabler means embedding risk assumptions within a company's growth plans and overall corporate strategy. "The most risk-resilient companies are already doing this," says Christopher Michaelson, a director in PwC's Strategy and Risk Institute. While that approach might seem like common sense, it is not common practice. Instead, risk management and corporate strategy tend to run on separate tracks. At the more risk-resilient companies, those tracks overlap.

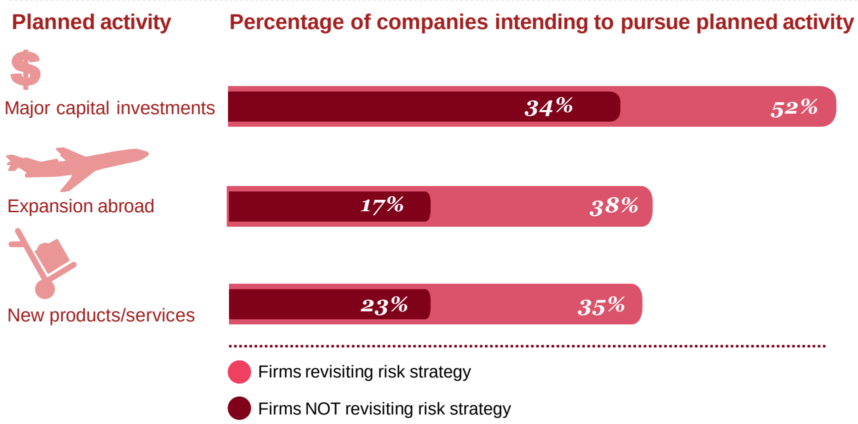
"Private companies have a real opportunity to differentiate themselves here," says Vitale. "By incorporating risk appetite and risk resilience into their strategic objectives, chief executives are likely to find that their businesses are more successful and profitable. Conversely, if a company omits risk considerations from its strategic planning, it makes itself more vulnerable to product failures, supply-chain disruptions, technology mishaps, and unsuccessful forays into new markets, to name just several unwelcome consequences."

Such consequences are not only felt by the company, but also noticed by customers and potential business partners. If, on the other hand, those parties see that a company is connecting risk-resiliency efforts to the heart of its business, they're more apt to want to engage with it. Without such engagement, a company may face limited growth prospects.

Indeed, private companies that seem most attuned to the importance of integrating risk concerns with corporate strategy are the ones that are pursuing growth most aggressively – outpacing their private-company peers in major capital investments, expansion into new markets abroad, and introductions of new products and services.

For these companies, risk-taking is an intentional choice, one that's tied to their growth strategy. It would stand to reason, then, that during growth-strategy discussions, senior management would want to address key questions concerning risk: What is the range of outcomes the company could experience as a result of pursuing Strategy X versus Strategy Y? Are those outcomes within the company's risk appetite? Is the company resilient enough to withstand the worst of those outcomes?

The greater a private company's focus on growth, the more inclined it is to rethink risk strategy

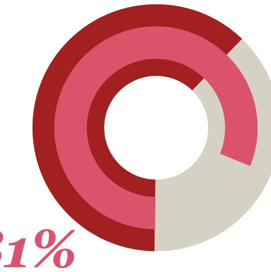


Source: *Trendsetter Barometer, PwC, 2012*

US private companies that sell internationally feel the greatest need to revisit risk strategy

62%

of private companies that acknowledge a need to revisit their risk strategy sell abroad



81%

of private companies that feel a need to revisit their risk strategy specifically in light of Black Swan events sell abroad

Source: *Trendsetter Barometer*, PwC, 2012

"CEOs are paid to be optimistic," notes Michaelson, "but the most effective ones aren't so enamored of the potential rewards that they're blind to how much risk the company can reasonably take."

Companies that sell internationally (particularly those selling in fast-growth markets) are most alert to risk considerations and feel the greatest need to revisit how they handle them. This isn't surprising, since such companies tend to have more-ambitious growth strategies generally[6] and are pursuing them in a complex global marketplace, all of which elevates their risk profile.

While US companies that are pursuing aggressive growth abroad realize they can ill afford to separate risk considerations from their growth agenda, companies overall have yet to migrate to an integrated approach. "The majority of businesses continue to treat risk management as an afterthought," says Michaelson. "Now is a good time to change that approach, but doing so will entail a cultural shift, and many companies simply don't want to expend the time and effort. They are likely to discover, however, that the cost of complacency is even higher."

6. Trendsetter Barometer Business Outlook, PwC

Dangerous disconnect
Private-company blind spots

Just under one-third of US private companies acknowledge a need to revisit their overall approach to risk,[7] despite ongoing uncertainty about the economy and other key factors affecting the health of their business. An even smaller percentage of US private companies say they have made changes in response to external shocks such as the Japanese tsunami, Arab Spring, and Eurozone crisis.

This inaction might suggest that the majority of private companies think they have a good handle on risk management. As it turns out, however, only a minority of private companies are very confident they'll be effective at key aspects of risk management over the next few years. Tellingly, they're least confident they'll be able to keep pace with the changing risk environment.

Consistent with their concern about the risk landscape's changeability, most private companies that are revisiting their risk approach feel they need to focus more on detecting a broad range of *emerging* risks. Yet the lion's share of private companies' total risk-management effort (75%) goes into preparing for known, recurring risks.

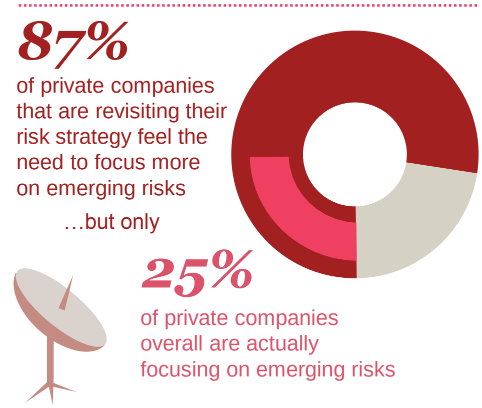
How to account for this disconnect? Quite possibly companies view the range of emerging risks out there as too large to adequately monitor and manage, so they're simply leaving things to chance. While the events of 2011 underscored the need for vigilance, those events have also shown that risk is an increasingly unpredictable and moving target – able to proliferate quite suddenly and on multiple fronts. Managing risk on that scale may strike many companies as near impossible.

In short, companies can't detect and monitor all possible risks (known, emerging, and unknown) in all places, all the time. No wonder most private companies don't plan to shift their risk approach accordingly. But is inaction a viable option? It isn't, says Vitale: "Now is not the time for companies to sit on their hands where risk is concerned. Rather, they should think about exploring new risk strategies that have evolved over the past few years, first in response to the global financial crisis and, more recently, in light of the risk events of 2011. What we're seeing is that by shifting the focus away from traditional risk *mitigation* and toward greater *resilience*, companies are getting a better handle on risk."

Only a minority of private companies are "very confident" about key aspects of their risk strategy

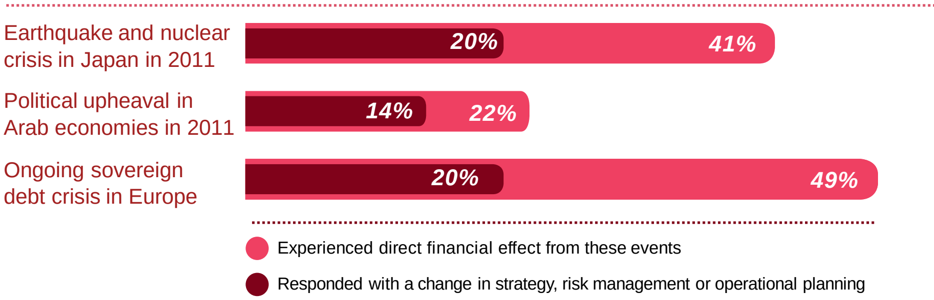
Source: *Trendsetter Barometer*, PwC, 2012

Emerging risks
Companies revisiting their approach to risk are more alert to emerging risks.



Source: *Trendsetter Barometer*, PwC, 2012

Risk disconnect
Despite the direct financial impact of major, disruptive events, most private companies haven't revised their approach to risk.



Percentages reflect the US private companies affected by these events.
Source: *15th Annual Global CEO Survey*, PwC, 2012

7. *Trendsetter Barometer, PwC, 2012*

Shifting the focus from cause to effect

Preparing for like consequences of unlike events

The difficulty with traditional risk-management approaches is that they try to cover the waterfront. This may strike many private companies as an unrealistic undertaking, particularly those with limited resources.

A minority of companies have begun taking a more-targeted approach – focusing on how to deal with major outcomes that could jeopardize the business (e.g., a facility shutdown, product discontinuance) rather than trying to anticipate the various circumstances that could trigger those outcomes (e.g., plant malfunction, earthquake, worker strike, new regulation, double-dip recession, etc.).

Consider a company's supply chain, for instance. A traditional risk-management approach attempts to identify, measure, monitor, and report the multiple potential causes of a supply-chain disruption, assess the likelihood that those potential causes will in fact trigger a disruption, and then minimize that likelihood (mitigate the risk). A tall order for any business, particularly since the various potential causes of a supply-chain disruption could evolve very quickly, as well as overlap/interconnect (e.g., natural disasters, market instability, political unrest, etc.).

Companies that are putting resilience at the center of their risk approach are essentially cutting to the chase. They recognize that while any number of potential circumstances could trigger a particular outcome, the outcome itself is what will be of ultimate consequence to the company – the thing that the company will have to deal with.

"That doesn't mean you're ignoring the potential causes," says Vitale. "Rather, it means that you start with a consequence and then peel back the various layers. Along the way, you should ask yourself a number of questions, including what business operations would be most at risk if a particular consequence were to occur and whether the company has mechanisms to either prevent or contain the damage that might accompany certain consequences."

Preparing for like consequences of un-like causes is certainly more economical, compared with traditional risk-management efforts, notes Michaelson: "Traditional methods inevitably involve wasted effort, since a large portion of the risks they try to mitigate won't ever come to bear for the company in question. Admittedly, there will also be some wasted effort in preparing for possible consequences, but to a much lesser degree."

Done right, a consequence-focused approach draws on input from people in the company who must ultimately respond to tangible business disruptions with concrete measures – people overseeing crisis management, operations, and corporate strategy, to name a few key areas.

This degree of orchestration could be a challenge for sprawling public companies, where the risk function often resides in its own special department, overseen by risk managers and/or a chief risk officer (CRO). While one could argue that a centralized risk-management function is in fact the more economical way to go, one could also counter-argue that without routine input from other parts of the company, the risk-management function might not be very effective when all is said and done.

For many private companies, this debate is academic. Most of them don't have a CRO.[8] Rather, at the majority of private businesses, the CEO or president is in charge of risk management. This makes it easier to align risk considerations with corporate strategy. As for companies that do opt to have a CRO, it's important that the person be the right breed of CRO – one who is strategic, collaborative, and business-oriented.

CEOs' daily planner

Many CEOs wish they could spend more time on strategy-setting and risk management.

46%

of private-company CEOs wish they could spend more time setting strategy and managing risk

54%

think they spend enough time already

Percentages reflect the US private companies' responses.
Source: *15th Annual Global CEO Survey,* PwC, 2012

Taking on more risk to pursue growth

A large minority of private companies are feeling the pressure to do just that.

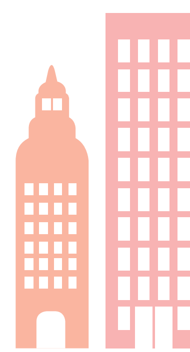
87%

of private companies say they take enough risk to capitalize on opportunities

…yet

40%

feel pressure to take on even greater risk to pursue growth



Source*: Trendsetter Barometer,* PwC, 2012

8. Just 15% of private companies have a CRO: *Trendsetter Barometer,* PwC 2012

Is BCM part of your risk-resiliency arsenal?

Business continuity management (BCM) is a key component of risk resilience. Although its core mission often centers on crisis management, BCM can also fortify a company's long-term ability to withstand external threats in general. That's because the interdependencies that make companies vulnerable to crises nowadays (e.g., IT networks, supply chains, globally connected financial systems) are the same interdependencies that could compromise the broader health and longevity of a business. By devising a BCM strategy that encompasses not only short-term survival of a catastrophic event, but also long-term corporate resilience, companies can improve their overall risk fortitude.

Risk-alert companies routinely update their BCM strategies to keep pace with changes in their business and operating models, with an eye toward how those changes could expose the company to new or heightened risks. Business leaders are realizing, however, that keeping pace with their changing risk exposure doesn't mean planning for every conceivable crisis (e.g., earthquake, flood, pandemic, political unrest, major mechanical failure at a critical facility, etc.). Rather, it means planning for how to deal with the main, direct consequence of a crisis (e.g., a facility shutdown) and the resultant disruption to the business.

"Most global organizations have disaster recovery plans in place," says Neil Kaufman, a director in PwC's Business Continuity Management practice. "However, the quality of those plans tends to vary widely."

Meanwhile, companies operating mainly in the United States often fall under the misimpression that they're immune to global shocks, believing that disasters overseas don't warrant BCM at home. But globally connected supply chains, banking systems, and technology platforms, among other interdependencies, have shown that crises from across the world can hit closer to home than previously thought.

Recognizing this, the US government is setting cross-industry guidelines. One program, the Voluntary Private Sector Preparedness Accreditation and Certification Program, or PS-Prep, aims to standardize BCM practices. Through its membership in the International Organization for Standardization (ISO), the United States has also been instrumental in the creation of a new international BCM standard: ISO 22301:2012, *Societal Security – Business Continuity Management Systems – Requirements* (released in spring 2012). The latter provides a framework for planning, establishing, implementing, operating, monitoring, maintaining, and continually improving BCM.

"There are multiple potential benefits to adopting these standards," notes Kaufman, "including enhanced confidence among stakeholders and prospective business partners, as well as lower insurance premiums and reduced legal liability." The same holds true for BCM in general – which is why companies that don't have a program in place might want to consider whether going without one is something they can truly afford.

Is your supply chain as resilient as you think it is?

Just one-third of private companies overall consider their supply chain a source of risk over the next few years.* This is surprising, considering the global interconnectedness of supply chains nowadays.

A company does not have to directly source from outside the United States to be affected by a supply-chain disruption somewhere else in the world. All it takes is for your supplier's main supplier to be impaired. While that supplier could be 10 miles down the road from you, there's a good chance it might also reside halfway around the world.

A sizable portion of the global supply chain resides in Asia. Most US private companies that have operations in Asia plan to grow them, according to PwC's *15th Annual Global CEO Survey* (94% expect to grow their Southeast Asia operations, 87% their South Asia operations, and 86% their East Asia operations). For many of those companies, it will make sense to source close to their Asia operations.

Private companies with sales operations in the Asia-Pacific region are notably more concerned about supply-chain risk than their peers,* as one might expect, in light of the 2011 earthquake in Japan and the floods in Thailand.

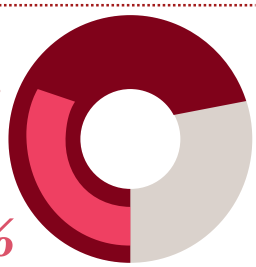
Nearly 60% of those companies flagged supply-chain issues as a risk concern. Not only are extreme weather events on the upswing in Asia,** but the unexpected impact of the Japan earthquake revealed glaring deficiencies in companies' risk assessment of supply chains. In many cases, that assessment failed to anticipate the risks posed by suppliers' suppliers.

A PwC survey has underscored the long-running, costly effects of supply-chain disruptions: More than half of all surveyed companies that experienced such disruptions saw greater share-price volatility for at least two years afterward.*** While private companies are shielded from the vagaries of the investment community, supply-chain disruptions are nonetheless apt to impact corporate performance. Considering that supply-chain vulnerability is only likely to increase in today's interconnected world, private companies that aren't giving the matter due attention might want to rethink that stance.

* *Trendsetter Barometer*, PwC, 2012: The percentage is higher among product-sector private companies (48%).
** http://sustainablesecurity.org/article/risk-extreme-weather-events-highlighted-intergovernmental-panel-climate-change
*** *From Vulnerable to Valuable: How Integrity Can Transform a Supply Chain*, PwC, 2010.

Supply-chain risk awareness

Companies active in markets abroad are more sensitized to supply-chain risks.



65%
of private companies that sell in China cite supply-chain issues as a risk ...compared with only

34%
of private companies overall

Source: *Trendsetter Barometer*, PwC, 2012

Internal controls

Can they fortify your resilience against game-changing risks? The answer is an emphatic yes.

Too often, companies don't have formal processes in place to assess and prepare for game-changing circumstances that could have reputational, competitive, legal, or operational implications.

For instance, a company might have no process for anticipating the various ways that its competitors' strategies could affect its business. One potential consequence of this is that the company might be slow to respond to a key competitor's innovations, losing significant market share as a result.

Other game-changing risks include those threatening a company's supply-chain integrity, workforce availability, information technology (IT) security, and regulatory compliance, to name just a few. Internal controls can strengthen companies' resilience against these risks.

In the case of IT risk, for example, what often springs to mind first are data breaches resulting from inadequate cyber security or financial losses stemming from prolonged failures in critical systems. However, many IT crises result not so much from weak spots in the technology itself but more from decision-making that fails to account for the full range of potential business consequences of technology related problems.*

The continuous operation and long-term reliability of a business depend on timely access to vital information and IT resources, both during and immediately following a disruptive event. Effective internal controls can help a business maintain and test not only IT continuity, but also the company's disaster recovery plans.

* *Managing Risk: Internal Controls for Private Companies, PwC, 2010*

In with the new, out with the old?

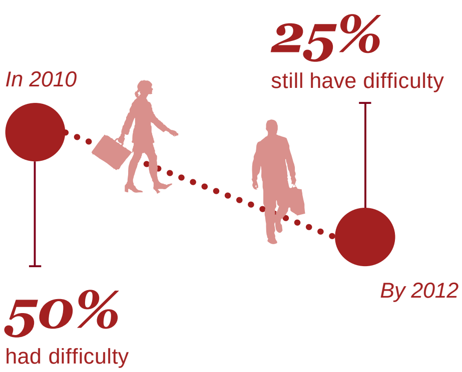
Yes and no

Adopting a consequences-based approach to dealing with risk isn't tantamount to abandoning all efforts to track risk factors and assess the probability that they'll trigger a business disruption. Instead, it's a shift of emphasis, with more focus on resilience and less on prediction.

"What we're seeing many companies do lately is establish robust business continuity programs that can help them weather crises," says Vitale. "Such programs involve not only reverse stress-testing, but also scenario planning, so that leaders can determine whether their companies will be resilient at the times of greatest need. These scenarios should look beyond your company's walls and include key vendors, helping you understand how their crises might ultimately impact you as well."

Risk awareness: Progress report

In the past two years, private companies have had less difficulty embedding risk awareness in their corporate culture.



Source: *Trendsetter Barometer*, PwC, 2012

Although scenario planning isn't a novel approach, many companies haven't bothered with it – that is, until recently. "The recession led a lot of businesses to contemplate scenario planning for the first time," says Michaelson. "That's because they didn't know if the recovery would take one year, two years, or longer. Depending on the recovery rate, among other factors, you might have Scenario A, for example, where a company would have to lay off X employees, or close Y stores. A different recovery rate would produce Scenario B, and yet another rate would lead to Scenario C, each requiring the company to come up with separate contingency plans."

Companies have also begun to establish monitoring systems that flag when a particular scenario is becoming more probable. Others are setting up cross-departmental crisis-management teams, as well as processes that can help their organizations react quickly to risk scenarios when they occur.

"Ultimately, the most successful risk strategies embed risk awareness into the very fabric of the company, including its operations, growth agenda, HR policies – in essence, throughout the company's entire culture," says Vitale. "The importance of doing this has always been understood by the more risk-resilient companies. What's changed is that over the past couple of years businesses in general have tried to heighten their overall alertness to risk."

Indeed, when we surveyed private companies on the topic of risk in early 2010, half of them said they had difficultly culturally embedding risk awareness and related behaviors throughout their company. When we asked them that question again in early 2012, just one-quarter cited such difficulty.

Conclusion

A culture of risk awareness at a company is the necessary platform for a truly effective risk approach. But it is not enough. Companies will also need to build on that platform in the following ways:

- Collaborate across and down the organization in setting and implementing the company's approach to risk
- Incorporate risk considerations in the company's strategic business planning
- Set risk boundaries (e.g., in the form of risk-appetite statements) and encourage executives to stay within those boundaries (e.g., tie risk-related performance incentives to risk-appetite statements)
- Focus on preparing for consequences – the ones most likely to disrupt or impair the business – rather than trying to predict the unpredictable (i.e., don't squander undue effort on guessing which of the many potential causes might actually occur)
- Apply reverse stress-testing – look at outcomes first and then identify possible causes
- Do rigorous and routine scenario planning, enabling better development of recovery strategies for mission-critical processes and vendors, as well as faster response rates
- Design and test resiliency strategies to ensure a flow of crucial information during a crisis

By adopting these measures, companies can be both resilient and take the necessary risks to pursue growth in a volatile world.

More information

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1 2011 Forbes America's Largest Private Companies List