

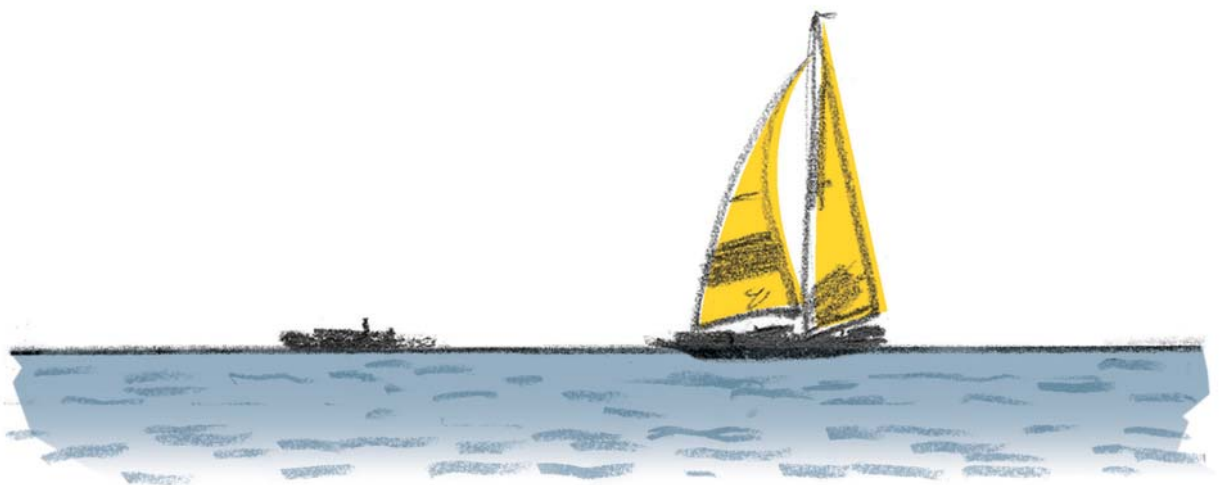


*CorporateGovernor* Series:

# Enterprise risk management: **Creating value in a volatile economy**

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**Addressing the concerns of the Corporate Governance Community** Summer 2009





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# Introduction

Risk is a reality of doing business. Whether large or small, public or private, domestic or international, companies today operate in a risk-filled world. In many cases, risk is necessary for long-term operational success; however, failure to control risk effectively can often lead to just the opposite, including damaged reputation, loss of profits, disruption in productivity or, in severe cases, the end of the entity altogether.

Although other priorities in running a business may have trumped risk management in the past, the planning and implementation of a formal program to better identify and oversee risk is of particular importance today. That is, in the current economic downturn, risk can emerge from both expected and unexpected channels relative to the past. In order to weather this economic storm, organizations must respond proactively, taking the proper steps to ensure they are assessing, prioritizing and managing all risks – both old and new – in a strategic and consistent way.

Enterprise risk management (ERM) is the leading approach to managing and optimizing risks, enabling a company to determine how much uncertainty and risk are acceptable to an organization. With a company-wide scope, ERM serves as a strategic analysis of risk throughout an organization, cutting across business units and departments, and considering end-to-end processes. In adopting an ERM approach, companies gain the ability to align their risk appetite and tolerance with business strategy by identifying events that could have an adverse effect on their organizations and then developing an action plan to manage them.

Furthermore, by applying ERM in conjunction with other operational elements in the current business environment, companies can also accomplish many of their governance-related tasks. Specifically, ERM can help organizations:

- Identify strategic risk opportunities that, if undertaken, can facilitate achieving organizational goals.
- Provide senior management with the most up-to-date information regarding risk that may be used in the decision-making process.
- Use the Sarbanes-Oxley compliance process to assist in identifying key financial risks.
- Establish co-dependency between the ERM initiative and considerations for Securities and Exchange Commission (SEC) reporting disclosures and other laws and regulations.
- Align annual performance goals with risk identification and management.
- Encourage and reward upstream reporting of business-risk opportunities and challenges.

**Proper risk management allows organizations to examine and evaluate opportunities and create value by taking risks carefully.**

# ERM frameworks

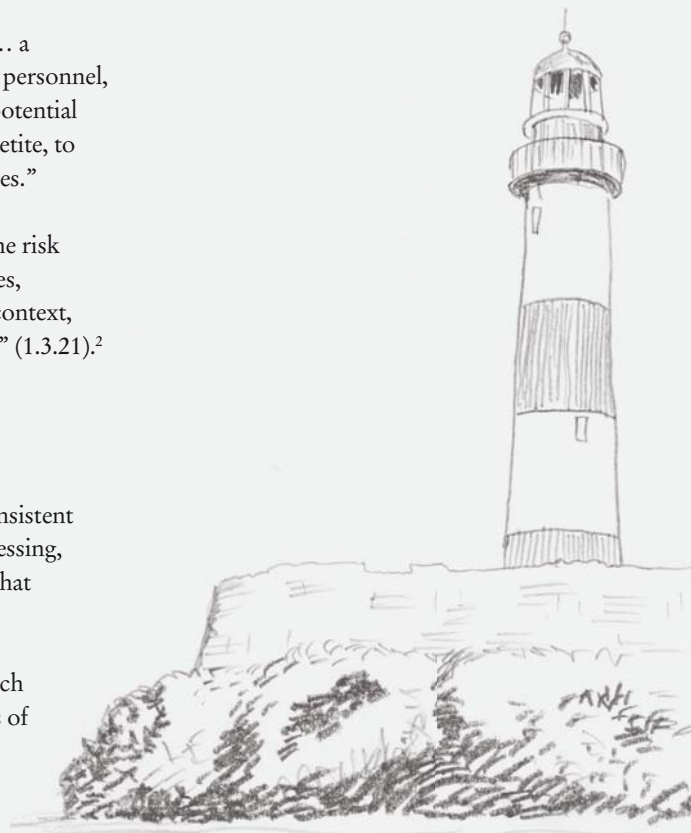
There are various ERM frameworks that a company could potentially follow – all of which should define the essential components, suggest a common language and provide clear guidance for enterprise risk management. In addition, each framework that is implemented should also describe an approach for identifying, analyzing, responding to, and monitoring risks and opportunities facing the enterprise.

## Among the more widely known frameworks and the related ERM definitions that they promulgate are:

- Published in its 2004 ERM framework,<sup>1</sup> The Committee of Sponsoring Organizations of the Treadway Commission (COSO) defines ERM as “... a process, effected by an entity’s board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives.”
- The Australian and New Zealand Standard on risk management defines the risk management process as “the systematic application of management policies, procedures and practices to the tasks of communicating, establishing the context, identifying, analysing, evaluating, treating, monitoring and reviewing risk” (1.3.21).<sup>2</sup>

## In addition, other ERM definitions that drive the establishment of risk management frameworks include:

- The Institute of Internal Auditors (IIA) defines ERM as “a structured, consistent and continuous process across the whole organization for identifying, assessing, and deciding on responses to and reporting on opportunities and threats that affect the achievement of its objectives.”<sup>3</sup>
- The insurance rating agency A.M. Best defines ERM as “a process by which companies systematically identify, measure, and manage the various types of risk inherent within their operations.”<sup>4</sup>



<sup>1</sup> The Committee of Sponsoring Organizations of the Treadway Commission, *Enterprise Risk Management — Integrated Framework* (2004)

<sup>2</sup> Joint Technical Committee OB-007, Risk Management, “AS/NZS 4360:2004” (August 2004)

<sup>3</sup> The Institute of Internal Auditors, Position Statement: “The Role of Internal Audit in Enterprise-wide Risk Management” (September 2004)

<sup>4</sup> A.M. Best, “Best Rating Methodology: Risk Management and Rating Process for Insurance Companies” (January 2008)

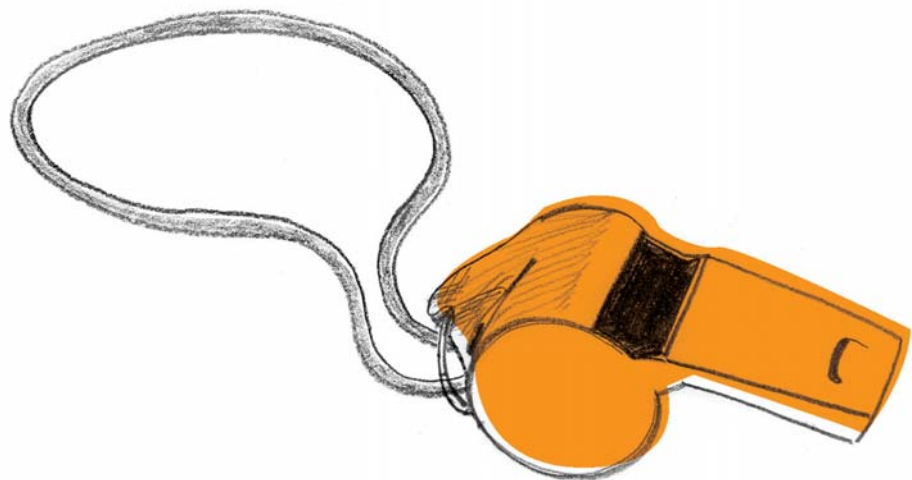
# Why enterprise risk management?

North Carolina State University in partnership with the American Institute of Certified Public Accountants recently conducted the *Report on the Current State of Enterprise Risk Oversight* in an effort to gain a better understanding of ERM practices across a wide range of organizations. Surveying approximately 700 companies, the research study found that more than 60 percent of respondents believed that the volume and complexity of risks have changed “extensively” or “a great deal” in the last five years. However, despite these sentiments, 44 percent of respondents had no enterprise-wide risk management process in place and had no plans to implement such a system.

In response to this answer, survey participants whose organizations had not implemented an ERM process were asked to provide some perspective into this decision.

While respondents could list more than one reason, the most common response (53 percent) was that they believed risks are monitored in other ways besides ERM. The next most common responses were “no requests to change our risk management approach” have been made (29 percent) and “too many pressing needs” keep them from launching an ERM process (24 percent). Of those same respondents, 18 percent also noted a belief that they “do not see benefits exceeding the costs.”

The question becomes then, in a severe economic downturn where companies are plagued with shrinking budgets and limited personnel, what is the real value of investing time and money into a strong ERM program?



# Why ERM: Your credit rating may depend on it

In the current economic state, lending has nearly come to a standstill. Companies must now demonstrate their creditworthiness more than ever before in order to gain financing. The current credit crunch has squeezed many organizations to their breaking point, leaving those companies unable to pay back lenders in a dangerous position, potentially leading to cut backs in production, decreased market share, layoffs or even the end of the business.

With access to capital limited, a company's credit rating has become vital to its borrowing power, which is where ERM comes into play. In 2005, Standard & Poor's (S&P) began analyzing the financial service industry's ERM practices, developing criteria for assessing the ERM procedures of financial institutions and insurance companies. Then in 2006, S&P expanded its analytical approach for assessing the trading risk management practices of energy companies. This led to the integration of ERM analysis into the rating process of energy trading firms in electricity marketing and agribusiness.<sup>5</sup>

Following the successful addition of ERM analyses to the ratings of these sectors, S&P concluded that nonfinancial organizations could also benefit from ERM analysis, providing meaningful insight into those companies' management capabilities and corporate governance.

As a result, ERM became a far more serious focus for corporate America in 2008 as S&P began incorporating ERM analysis into the credit-rating process for nonfinancial companies. As part of the new S&P approach, organizations that fail to implement ERM in a formal, strategic way are in danger of suffering ratings downgrades. Alternatively, companies that fully adopt ERM can improve their credit ratings, while also benefiting from the other aspects of having a strong ERM program.

In evaluating the credit ratings of nonfinancial institutions, S&P will focus on two universal components<sup>6</sup> of ERM – risk management culture and strategic risk management.

#### **Risk management culture includes:**

- risk management organizational and governance structures
- roles, capabilities and accountabilities of risk management staff
- risk management communications and transparency
- risk management policies and metrics
- influence of risk management on budgeting and management compensation

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<sup>5</sup> For more information about Standard & Poor's review of ERM practices, visit [www.erm.standardandpoors.com](http://www.erm.standardandpoors.com)

<sup>6</sup> For now, S&P has deferred consideration of the other two applicable components of ERM that they initially were going to also factor into the process – emerging risk management and risk-control processes. The background and framework will be communicated later this year.

## Why ERM: Your credit rating may depend on it (continued)

### Strategic risk management includes:

- management's view of the most consequential risks, including their likelihood and potential effect on credit
- frequency with which top risks are identified and how often the identification is examined and updated
- influence of risk sensitivity on liability management and financing decisions
- role of risk management in strategic decision-making

Throughout 2009, S&P plans to gather risk information through its regular review meetings with rated nonfinancial companies, resulting in the development of reliable ERM performance benchmarks.

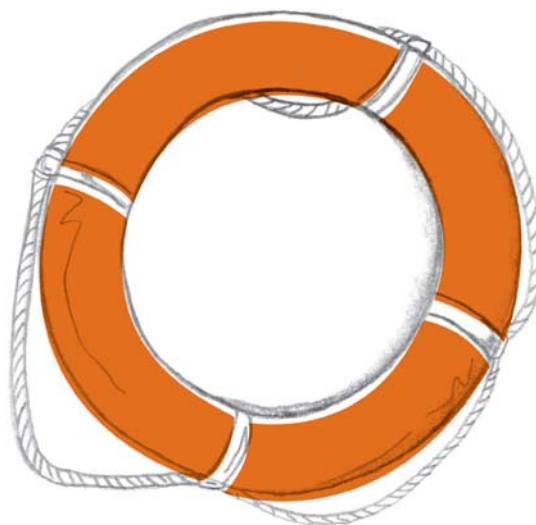
Once appropriate benchmarks are established, S&P plans to publish criteria that will eventually lead to evaluation metrics and possible scoring measures of ERM capabilities, with the end goal being to enhance the evaluation of management performance, an existing part of the rating agency's analytical framework. S&P intends to score ERM performance very broadly at first, using qualitative terms such as "favorable ERM" versus "unfavorable ERM," with the hopes of developing more quantitative metrics over time.

The touchstone for scoring ERM capabilities will be evaluating whether a company consistently identifies, assesses and manages exposures to risk and losses within predetermined tolerance objectives. S&P does not expect to score ERM capabilities until at least late 2009, giving companies time to put robust ERM implementation processes in place.

### Insurance Industry

The insurance industry is no stranger to enterprise risk management and its role in the credit rating process. Since 2005, S&P has included an ERM analysis in its rating evaluations of financial institutions and insurance companies, utilizing a six-step economic capital (EC) model. Credit agency Fitch Ratings has developed its "Prism" model that analyzes an insurer's EC by determining capital adequacy using a conjectural measure. The model was created in 2006 and has since been utilized as a "beta" version for testing and development purposes. Moody's is currently building its own model to analyze an insurer's EC adequacy that includes a scorecard for each component of its model. This information, combined with Moody's opinion of the EC method in use and of the insurer's capital strength, will determine a company's overall ratings. Lastly, credit agency A.M. Best Company has also developed a proprietary capital model, which determines a Best's Capital Adequacy Ratio (BCAR) that is based on a company's balance sheet, operating metrics and overall business health. To learn more, please visit the rating agencies' Web sites:

- Standards & Poor's: [www.standardandpoors.com](http://www.standardandpoors.com)
- Fitch Ratings: [www.fitchratings.com](http://www.fitchratings.com)
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- A.M. Best Company: [www.ambest.com](http://www.ambest.com)



# Why ERM: Rethink risk management in a down economy

Risk is active, and therefore, constantly evolving due to ongoing changes in external and internal factors. Whether there are modifications in business systems or processes, or events in the industry, a company with a strong ERM strategy will periodically review its program and risk profile, allowing management in charge to respond to these changes as needed.

Since the start of the current recession, an array of risks have bombarded organizations – some emerging and others more common – that may have been underestimated or overlooked in the past when the economy was more stable. In light of this change, companies must now take a more comprehensive approach in identifying risk events that could potentially affect

the achievement of business objectives. This begins by thinking in a different way – creatively, abstractly, broadly – considering all possible incidences on an entity and business unit level, as well as those other factors that could combine and interact to influence the risk profile (**Table 1**).

Quantifying all risk is difficult. For emerging risks, very little, if any, relevant historical information is available. Unfortunately, this can serve as a stumbling block for ERM, which is contingent on ensuring that all significant risks are captured and incorporated into a framework. This is done to facilitate the holistic approach to managing risk that is the foundation of an effective ERM process.

**Table 1: Risks to consider in the down economy**

Risk type	Risk
Financial	<ul style="list-style-type: none"> <li>Reporting integrity</li> <li>Financial statements/disclosures are misstated according to accounting/industry standards</li> <li>Insufficient liquidity</li> <li>Lack of reliability in the systems reporting key financial data</li> <li>System security vulnerabilities</li> <li>Inadequate recording/oversight of financial information</li> <li>Estimates are not adequate</li> <li>Interest rate/market risk</li> <li>Foreign currency exchange</li> <li>Credit risk</li> <li>Off balance sheet risk</li> <li>Product-liability risk</li> <li>Tax rate risk</li> <li>Transactions are not properly approved</li> <li>Inability to raise capital</li> <li>Asset/liability risk</li> <li>Investment risk</li> </ul>
Compliance	<ul style="list-style-type: none"> <li>Non-compliance with employment practices (FMLA, EEO, etc.)</li> <li>Environmental contamination</li> <li>Record retention policy</li> <li>Regulatory noncompliance</li> <li>Inability to meet contractual obligations</li> <li>Breaching existing capital requirements</li> <li>Non-adherence to debt covenants</li> <li>Data used to support compliance is unreliable</li> <li>Fraud</li> <li>Adherence to 401K/benefit plan requirements</li> <li>Insider trading</li> <li>OSHA violations</li> <li>HIPAA violations</li> </ul>
Strategic	<ul style="list-style-type: none"> <li>Acquisitions and strategic alliances</li> <li>Strategic planning does not consider external impacts</li> <li>New products and services</li> <li>Customer demand shortfall</li> <li>Disruptive technologies</li> <li>Competitive pressure</li> <li>Loss of key customers</li> <li>Misaligned products</li> <li>Counterparty failures</li> <li>Customer pricing pressure</li> <li>Business concentration</li> <li>Distribution strategy</li> <li>Litigious trends and judicial uncertainty</li> <li>Research and development</li> <li>Reputation risk</li> <li>Insufficient governance structure and practices</li> </ul>
Operational	<ul style="list-style-type: none"> <li>Loss of key personnel</li> <li>Supply chain failures</li> <li>Obsolete technology</li> <li>Insufficient information technology governance</li> <li>Natural disasters</li> <li>Acts of terror</li> <li>Third-party outsourcing</li> <li>Security breaches</li> <li>Lack of business continuity/disaster recovery planning</li> <li>Service quality</li> <li>Project/change management</li> <li>Business disruption/system failures</li> <li>Lack of sufficient contractual oversight</li> <li>Process control risk</li> </ul>

## Why ERM: Rethink risk management in a down economy (continued)

Not surprisingly then, the management of high-impact, rare risks is often the greatest challenge in the ERM process. One method for looking at these and other risks is through the use of a risk profile (Figure 1), where risk events are positioned on the diagram based on their impact and likelihood. Once an event's placement is made and analysis completed, (Table 2) the necessary risk management actions can then be determined.

Figure 1: Sample risk profile

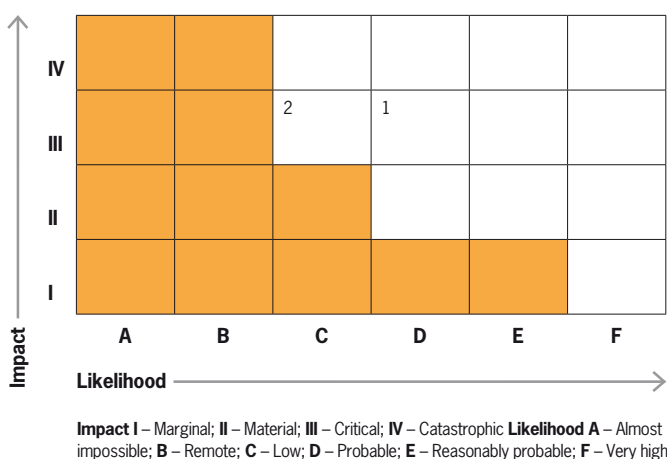


Table 2: Sample risk analysis report

#	Risk/Risk event	Trigger	Consequences	Current controls	Key risk indicator	Risk response	Risk		
							Profile	Rating	Rating
1	Loss of key customer (financial/strategic risk).	Pricing pressures due to economic conditions and/or competition.	Decrease in revenue and liquidity.	Monitoring of current client base. New product development process.	Change in market share. Decrease in customer demand and/or timeliness of payment.	Increase monitoring of competitors. Use of customer surveys. Increase modeling of customer base and demands.	III	D	High
2	Lack of continuity associated with management turnover and reorganization resulting in failure to meet strategic goals (strategic risk).	Personnel change without sufficient knowledge transfer.	Lack of familiarity with business model resulting in incorrect accounting, broken commitments and/or insufficient knowledge of business arrangements.	Strategic plan exists and roles and responsibilities are defined. Board approves appointment of key executives. Key executives establish organizational structure and appoint necessary personnel to complete organizational goals.	Analysis of current industry and organizational turnover trends. Analysis of results from employee exit interviews.	Formal succession planning and cross training of positions implemented. Planning committees appointed to address key personnel changes in the organization.	III	C	High

## Why ERM: Rethink risk management in a down economy (continued)

As noted previously, one of the benefits of ERM is that it looks at a full range of possible events, enabling a company to identify all of its risks, as well as potential areas of opportunity. Scenario analysis can assist in this process in that several diverse risk events are analyzed in conjunction with various possible future events over a period of time (e.g., one to three years). In the scenario process, not only does an organization seek to identify events that may not have occurred in the past, but it also helps to assess the likelihood of an event or events and related risk event correlations. Moreover, as there are significant new risk events occurring today that were not considered in the past, having a successful scenario analysis process in place is integral in the ongoing management of risk.

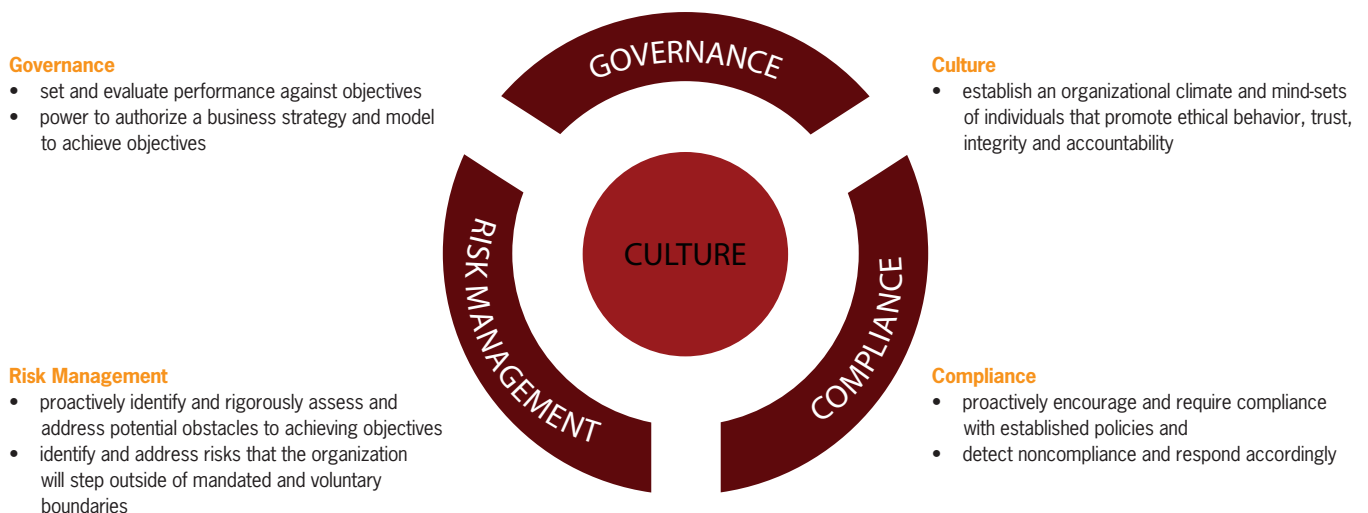


# Why ERM: Create stronger governance and corporate compliance

More frequently than not, shareholders and regulators are now demanding greater corporate transparency, making strong corporate governance a necessary component to almost every business. Enterprise risk management can contribute to successful, compliant and effective governance, enabling companies to better understand and measure those risks that threaten strategic objectives. Moreover, ERM provides information that helps quantify business performance, narrow the focus of controls and streamline compliance efforts.

As part of this process, some organizations have begun to use their risk objectives to create an integrated governance, risk and compliance (GRC) management framework to help drive their compliance initiatives (Figure 2). This strategy is promoted by the Open Compliance and Ethics Group (OCEG), of which Grant Thornton is a founding member. By establishing a GRC framework, companies are able to set their governance and enterprise risk objectives first, and then use these objectives to define compliance control requirements.

Figure 2: Integrated governance, risk and compliance (GRC)<sup>7</sup>

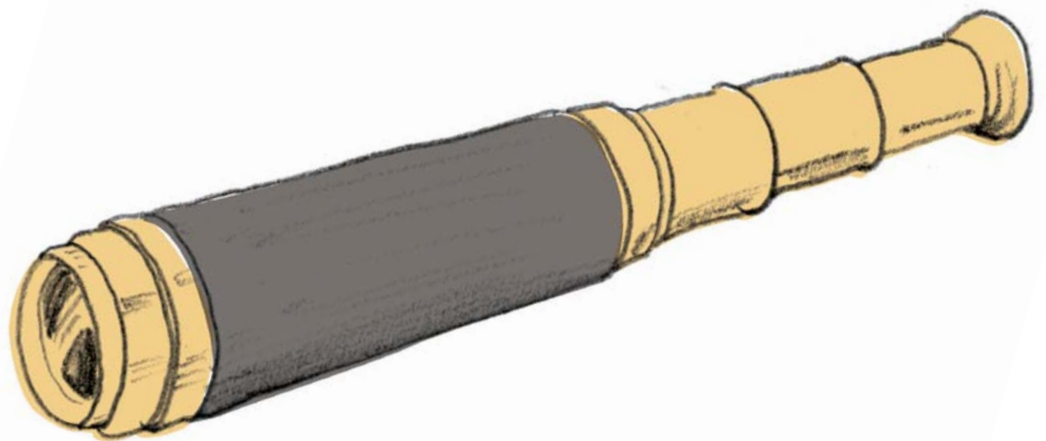


<sup>7</sup> Open Compliance and Ethics Group (OCEG)

## Why ERM: Create stronger governance and corporate compliance (continued)

Furthermore, the integration of governance, risk management, compliance and ethics can also help an organization more effectively and efficiently drive performance. Governance establishes objectives and, at a high level, the boundaries inside of which an entity must operate. Risk management helps a company identify and address potential obstacles to achieving objectives. Compliance management ensures that the boundaries are well set, and that the organization does indeed conduct business within those boundaries. Finally, a strong culture provides a safety net when formal controls and structures are weak or nonexistent while, at the same time, providing an environment that helps the workforce reach its highest level of productivity. High-performing organizations master and integrate these disciplines for maximum effectiveness and responsiveness, allowing their companies to leverage innovation in one area across the entire enterprise to address all set requirements.

Last, but certainly not least, an effective ERM program enhances a company's governance structure in that the "tone at the top" message is promulgated as one where compliance with laws, regulations and internal policies and procedures is mandatory and non-compliance is unacceptable. This assists in motivating desired conduct and provides assurance to management that they are operating within legal, contractual, internal, social and ethical boundaries. Moreover, ERM further assists in establishing the fundamentals of a good governance environment and structure, promoting a common risk language and collaboration on risk management issues throughout the organization (e.g., sharing of any risk issues identified by internal audit, compliance officer and others).



# Why ERM: Identify strategic opportunities

Historically, enterprise risk management has been largely viewed as eliminating or reducing risk exposures. However, more companies are beginning to understand that this focus is too narrow or constraining in aiding a company to meet its goals. That is, risk is not merely a negative for an organization, but should also be viewed as being potentially positive. By accepting and managing risk, companies have the ability to measure the likely reward for taking on some risk. They have the ability to maximize profit and increase shareholder value by limiting some risks and exploiting others.

Therefore, risk tolerances and related risk profiles should be established to meet organizational strategic objectives, and they should be promulgated throughout organizations. This highlights the importance of how much risk to take and what type of risk is critical to the success of the business. Risk must be understood and measured not only in everyday decisions,

but also in creating innovation within an organization. This is a more complete view of risk management, which entails strategic risk management and incorporating risk considerations in the strategic planning process. Companies must view risk as potential opportunity while also understanding there are possible undesirable outcomes. The future success of companies will depend on the ability to weigh the expected risks versus rewards on an ongoing basis. Successful companies need a complete understanding of ERM, which analyzes what risks to avoid and what risks to exploit. Also critical is implementing a financial planning process, which is a part of an integrated strategic and risk management program. This process needs to be consistently updated and should measure the risks taken and related results in conjunction with an organization's overall risk profile and risk tolerance.



# Next steps

It's easy to dismiss any new process as unnecessary overhead in times of financial unrest. However, ERM is justifiably different in that, when properly implemented, it not only provides improved risk information for better decision-making, but also overlaps with many measures already undertaken by organizations to comply with regulations. In establishing such a process, there are several helpful steps that a company should consider. They include:

## **1. Clearly define the organization's risk appetite and communicate it throughout the organization.**

A proper "tone at the top" is established through actions demonstrating that risk management is a key component of organizational success. The development of a formal risk policy statement, risk policy manual, risk committees and applicable governing charters is integral to this process, helping to solidify a superior risk awareness tone and culture. It's important to note that a punitive culture should be avoided, as it reduces the possibility that all risk scenarios and related failures and learnings are communicated to improve a company's risk management practices.

## **2. Create a documented risk management structure.**

While many organizations have risk management practices in place, a formally documented ERM framework is not always present. That is, although companies may believe they utilize an ERM framework that generally follows the COSO ERM guidance, without sufficient formal risk management practices, the likelihood of unidentified, insufficiently captured and/or monitored risks and/or related opportunities is greatly increased. Organizations should assess what practices are already in use and leverage them into a structure that ensures a "top-down, bottom-up" approach, such that all corporate business units, local and geographical risks are identified and evaluated. Where applicable, companies should build on what already

works, enhance what they already have in place and standardize wherever possible. Furthermore, even if a program is working well, an organization should continue to review its practices for weaknesses that may evolve with changing business conditions.

## **3. Create a uniform risk language, as well as define and communicate risk-related roles and responsibilities.**

By establishing the necessary risk committees and ensuring the appropriate individuals know what is expected of them, the potential success of an ERM program is notably enhanced. Additionally, creating management objectives, including incentive compensation that is tied to risk management goals, may also help in this process (see Appendices A and B).

## **4. Maximize the use of technology.**

Technology is a key component of any successful ERM initiative. As long as the necessary risk data is available, technology can be used to facilitate the creation of necessary reports and related monitoring tools.

## **5. Address risks in the strategic planning and decision-making process.**

The strategic planning process should be one that is continuous, whereby obstacles, threats and potential impacts are addressed. It should also include regular reporting of risk metrics to the board and related management.

Depending on the maturity of a business and the formality of its risk management program, an organization may even benefit from a third-party review and consultation. Utilizing outside consultants can help a company review, monitor, assess and improve its risk management capabilities over time. With these steps, a company can create an ERM solution that improves risk information, leading to stronger strategic decisions, fewer surprises and enhanced governance.

# Conclusion

At its heart, ERM is a forward-looking, process-oriented approach that provides business intelligence to companies to help better plot the future and make more informed decisions. When implemented correctly, ERM can provide organizations with a means of leveraging risks for greater performance, building a foundation for competitive advantage and ultimately establishing themselves as market leaders.

In theory, it is easy to understand how ERM could potentially add value to any organization, yet in reality, assigning the time and resources to create an ERM initiative is often overlooked. Strategic balance is needed. Organizations that embrace ERM and build it into the core of their enterprise should no doubt anticipate reaping the fruits of their labor. At the same time, companies must also realize that implementing such a program is far from easy and cannot happen overnight if done properly. However, for those organizations that choose to weather this economic storm with the aid of ERM, the benefits of their efforts today will likely remain long thereafter.

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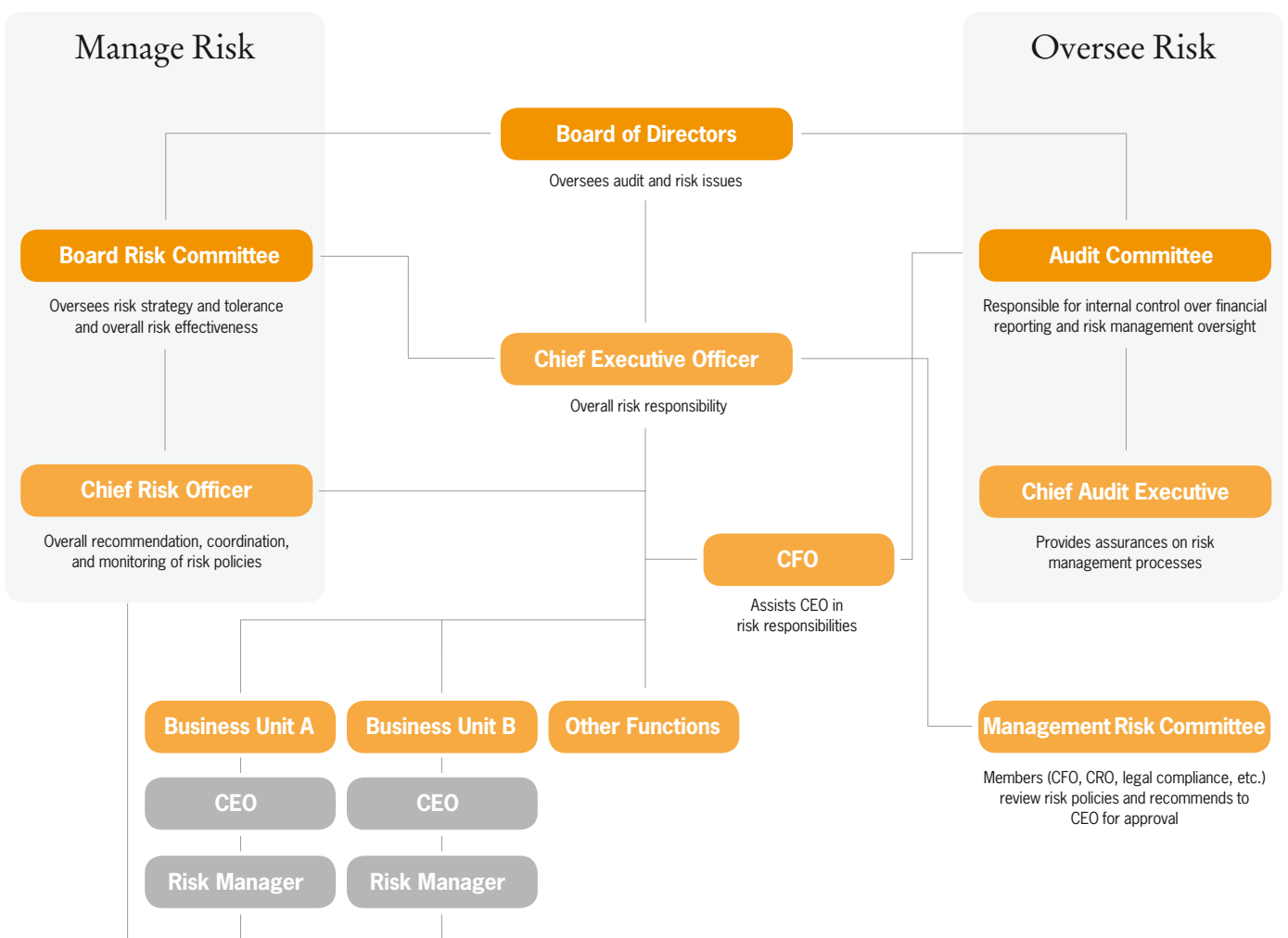


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# Appendix A: Business unit risk organizational chart



# Appendix B: Business unit risk management roles and responsibilities

## **Board and, where applicable, Board Risk Committee**

- Sets the requirements for superior risk management measurement, monitoring and reporting, as well as the organization's appetite for risk
- Ultimate strategic oversight of risk within organization

## **Board Audit Committee**

- Responsible for oversight of the internal controls of an organization including oversight that appropriate risk management processes are in place

## **Chief Risk Officer (CRO)**

- Recommends risk management policy and tolerance for approval by CEO
- Ensures risks are identified
- Develops risk measurement methodologies and tools to quantify risk and assures such are utilized
- Conducts overall risk coordination
- Analyzes and reports on risk exposures
- Provides ongoing risk training
- In some organizations, takes an active role in assisting line management in developing risk strategies

## **Chief Executive Officer (CEO) with assistance from Chief Financial Officer (CFO)**

- Approves risk policy and tolerance (initially suggested by CRO then reviewed by Internal Risk Committee)
- Manages overall risk
- Approves risk tolerance
- Takes action to mitigate risk
- Assures proper control environment is in place

## **Risk Management Committee**

- Recommends risk policy and guidelines to CEO and monitors risks

## **Business Unit CRO**

- Assures that each unit's stated risk management tolerance is baked into each business unit's planning and budgeting processes
- Similar to BU CEO with additional monitoring responsibilities

## **Business Unit Personnel along with CEO/CFO**

- Follows organization's risk policy
- Identifies and reports all risk exposures to CRO and CEO
- Assures risk information is reported to CRO and CEO

## **Internal Audit**

- Assures the Board and Audit Committee that each business unit's activities effectively manage risk according to the organization's risk tolerance
- In some organizations, assists in leading the implementation of an enterprise-wide management risk assessment process

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Oakbrook Terrace	630.873.2500	<b>Utah</b>	
<b>Kansas</b>		Salt Lake City	801.415.1000
Wichita	316.265.3231	<b>Washington</b>	
<b>Maryland</b>		Seattle	206.623.1121
Baltimore	410.685.4000	<b>Washington, DC</b>	
<b>Massachusetts</b>		Alexandria, VA	703.837.4400
Boston	617.723.7900	McLean, VA	703.847.7500
<b>Michigan</b>		Washington, DC	202.296.7800
Detroit	248.262.1950	<b>Wisconsin</b>	
<b>Minnesota</b>		Appleton	920.968.6700
Minneapolis	612.332.0001	Madison	608.257.6761
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