2003 Protecting Value Study: Managing Business Risks

Financial Executives Research Foundation

Protecting Value 2003 *Managing Business Risks*

STUDY

Has the world of risk really changed?

Executive Summary and Report

The world has changed in countless ways in the past 18 months. Words like "terrorism," "catastrophe," and "corporate scandal" have entered mainstream vocabulary. The public suddenly has a perspective on risk—that the world is a much riskier place than it once was.

Photographs of the World Trade Center collapse and magazine cover stories on corporate financial mismanagement are images etched in many people's minds. But what is the real state of risk? Has the world really changed? Have those responsible for managing risk addressed this change?

To discover the truth, chief financial officers (CFOs), treasurers and risk managers—the people charged with understanding risk and protecting their company's value—from the world's top corporations were surveyed for the 2003 Protecting Value Study. The results may surprise you…

RESEARCH PARTNERS:

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Given the importance of risk management to protecting value, it is critical for companies to bolster communication between financial executives and risk managers to ensure quick and efficient recovery in the event of a loss.

The value a company creates on behalf of its customers and shareholders is its greatest asset. As a result of new threats like terrorism and corporate financial mismanagement, corporate resources have been reallocated—but are companies better prepared for disruptions to their top earnings drivers than they were a year ago?

Building on the findings of the *2002 Protecting Value Study*, the 2003 study asked nearly 400 CFOs, treasurers and risk managers at the world's largest corporations to identify:

- Their company's "top earnings drivers" *(See Exhibits I, II and III);*
- The "top hazards" to those earnings drivers *(See Exhibit IV);*
- The impact a major disruption to each earnings driver would have on their company's earnings *(See Exhibits V and VI);*
- How well-prepared they are to recover from such a disruption *(See Exhibits VII and VIII);* and
- How well their organization understands these hazards, their potential impact, and their company's level of preparation.

Results indicate:

- Financial executives (CFOs and treasurers) view the challenges of protecting assets differently from risk managers;
- Business continuity planning is not sufficiently aligned with top earnings drivers in many companies; and
- Recent events may affect respondents' perception of top hazards to their earnings drivers, but have little effect on their firm's overall level of preparedness.

Different Views Regarding Top Earnings Drivers

Twenty-eight percent of all respondents cited “Personnel and Customer Support” as one of their top three earnings drivers, followed closely by “Manufacturing Plant, Equipment and Process.” Of particular significance, financial executives were more likely to cite “Personnel and Customer Support” as their top earnings driver, compared with risk managers, who were more likely to cite “Manufacturing Plant, Equipment and Process.”

The overall response in 2003 marks a significant change from the findings in the *2002 Protecting Value Study,* in which respondents cited “Manufacturing Plant, Equipment and Process” as their top earnings driver followed by “Personnel and Customer Support” and “IT/Telecommunications Systems” *(See Exhibits I and II).*

Exhibit I: Top Three Earnings Drivers

Earnings Driver	2003 Financial Executives	2003 Risk Managers	2003 All Respondents	2002 All Respondents
Personnel and Customer Support	36%	20%	28%	20%
Manufacturing Plant, Equipment and Process	19%	30%	24%	32%
Raw Materials/Inventory	17%	21%	19%	16%
IT/Telecommunications Systems	12%	15%	13%	20%
Delivery/Logistics	12%	12%	12%	9%
Intellectual Property	4%	3%	4%	3%

Exhibit II: Top Three Earnings Drivers by Industry Sector

Earnings Driver	2003 All Respondents	Industry Sector: Financial Services	Non-Tech Mfg.	Process	Tech Mfg.	Trade	Other
Personnel and Customer Support	28%	42%	24%	20%	28%	33%	27%
Manufacturing Plant, Equipment and Process	24%	8%	37%	24%	22%	5%	21%
Raw Materials/ Inventory	19%	9%	18%	36%	12%	24%	15%
IT/Telecommunications Systems	13%	30%	7%	5%	25%	16%	18%
Delivery/Logistics	12%	11%	11%	8%	7%	22%	13%
Intellectual Property	4%	0%	3%	6%	5%	0%	5%

Looking at responses from the financial services sector, "Personnel and Customer Support" was cited as the top earnings drivers by 42 percent, while 30 percent cited "IT/Telecommunications Systems." This contrasts with 2002 results, in which "Personnel and Customer Support" was cited only by 20 percent of respondents from the financial service sector, while 52 percent cited "IT/Telecommunications Systems." Thus, there appears to be a trade-off this year between concerns associated with personnel versus technology *(See Exhibit III)*.

Exhibit III: Top Earnings Drivers Cited by Respondents from Financial Services Sector

Earnings Driver	2003 Financial Executives	2003 Risk Managers	2003 All Respondents	2002 All Respondents
Personnel and Customer Support	59%	22%	42%	20%
IT/Telecommunications Systems	17%	44%	30%	52%

Property-Related Hazards Remain Greatest Earnings Threat

Overall, property hazards (e.g., fire/explosion, natural disasters, mechanical/electrical breakdown, terrorism/sabotage/theft, service disruption, supply shortage/strike and cybercrime) continue to collectively pose the greatest threat to earnings drivers, according to 59 percent of this year's respondents.

Financial executives, however, are more likely than risk managers to cite non-property-related hazards as posing the greatest threat to earnings *(See Exhibit IV).*

Yet, in last year's *Protecting Value Study*, overall, respondents were less likely to cite "improper management and employee practices" as the most significant threat to their firms' top earnings drivers (11 percent). This year, however, 18 percent of all respondents cited this factor as the most significant threat to their top earnings drivers, with a marked difference in perspective between financial executives (23 percent) and risk managers (12 percent).

These results indicate that financial executives may be reacting more strongly than risk managers to newly emerged threats to corporate prosperity, such as financial mismanagement.

Exhibit IV: Hazards Affecting Top Three Earnings Drivers

	2003 Financial Executives	2003 Risk Managers	2003 All Respondents	2002 All Respondents
Property-Related Hazards				
Fire/explosion	7%	21%	14%	14%
Natural disasters	9%	16%	12%	14%
Mechanical/electrical breakdown	11%	10%	11%	10%
Terrorism/sabotage/theft	8%	8%	8%	13%
Service disruption	7%	6%	6%	10%
Supply shortage/strike	4%	3%	4%	14%
Cybercrime	2%	7%	4%	n/a
Total property-related hazards	48%	71%	59%	75%
Other Hazards				
Improper management and employee practices	23%	12%	18%	11%
Pricing volatility	11%	4%	7%	5%
Product recall	4%	3%	4%	n/a
Personal accident	3%	2%	2%	3%
Government/ regulatory risk	2%	1%	2%	3%
Contamination/ environmental	1%	1%	1%	3%
Other	8%	6%	7%	n/a
Total non-property-related hazards	52%	29%	41%	25%

A Major Disruption Threatens Business Continuity

This year, two-thirds of respondents said that a major disruption to their top earnings driver either would cause a sustained hit to their firm's earnings or actually threaten their business continuity. This figure is down 10 percent from the findings of last year's study *(See Exhibit V)*.

Does this mean that companies are doing a better job aligning their resources with their top earnings drivers and would expect only a one-time hit to earnings versus a threat to their business continuity? Regardless, perceptions varied significantly between financial executives and risk managers *(See Exhibit VI)*.

Exhibit V: Impact of a Disruption to a Top Earnings Driver
(2002 Results in Parentheses)

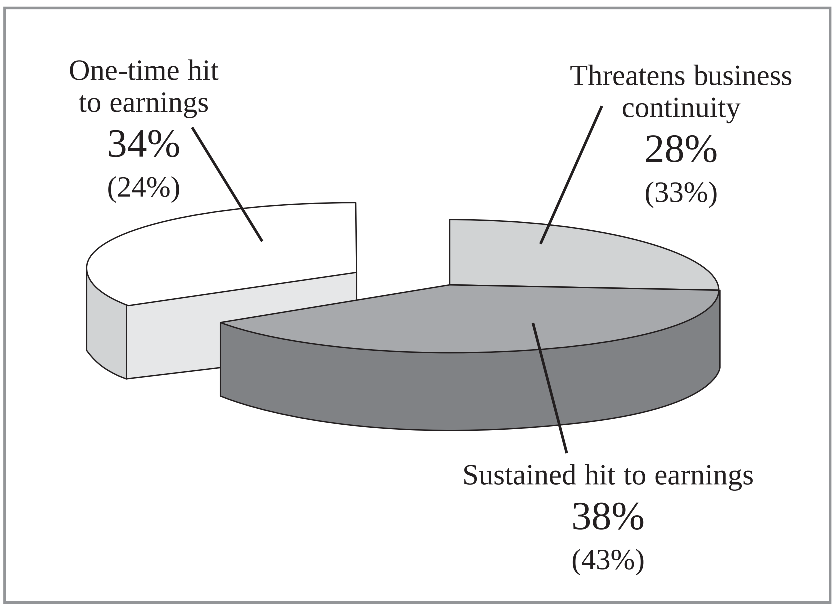


Exhibit VI: Impact of a Disruption to a Top Earning Driver

Contingency Planning Efforts are Insufficient

In the *2002 Protecting Value Study*, more than 50 percent of respondents indicated they were not well-prepared to recover from a major disruption to their top earnings driver.

This year, however, companies appear to be somewhat better prepared. By rating themselves from “Poor” to “Excellent,” respondents were asked how well-prepared they were to recover from a major disruption to their top earnings driver. Overall, only one-third of respondents cited their extent of preparation for a major disruption to their top earnings driver was “Fair” (30 percent) or “Poor” (4 percent) *(See Exhibits VII and VIII)*.

Additionally, the level of preparedness across all earnings drivers is relatively consistent, with the noted exception of “IT/Telecommunications Systems” and “Intellectual Property” for which respondents appear to be better prepared *(See Exhibit VIII)*.

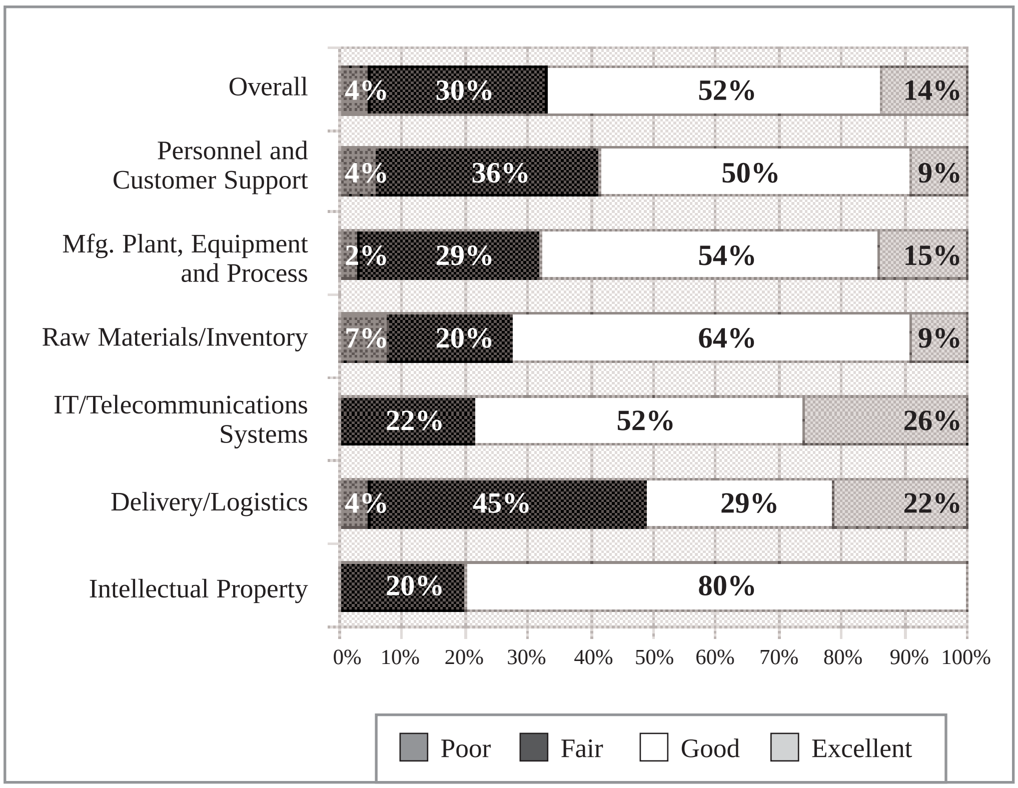
Nevertheless, 34 percent of respondents said their companies are still not well-prepared to protect their top earnings driver and there is room for improvement. Financial executives and risk managers are advised to assess their own level of preparedness.

Overall, compared with risk managers, financial executives believe their firms are less prepared to recover from a major disruption to their top earnings driver *(See Exhibit VII)*.
Given these findings, one must ask: “What should be a sufficient level of preparation for protecting a firm’s top earnings driver?”

Exhibit VII: Extent of Preparation to Recover from a Major Disruption to Top Earnings Driver

	2003 Financial Executives	2003 Risk Managers	2003 All Respondents
Excellent	12%	17%	14%
Good	48%	56%	52%
Fair	35%	25%	30%
Poor	5%	3%	4%

Exhibit VIII: Extent of Preparation to Recover from a Major Disruption (by Top Earnings Driver)



Smaller Companies More Likely to Rely on Insurance

In 2003, 26 percent of respondents from companies with less than US$1 billion in sales said they have "completely transferred to others" the overall risk associated with their top earnings driver, including damage, liability and business interruption. By contrast, only 16 percent of companies with more than US$1 billion in sales cited full risk transfer.

Is Risk Management an Investment or an Expense?

Overall, this year's study reveals that the corporate world views risk management as a long-term proposition. For example, more than 80 percent of respondents reported no significant shift in their risk management mindset post-September 11, 2001—either strategically or operationally.

Additionally, 85 percent of respondents indicated they view risk management as an investment. In particular, those who view risk management as an investment do so because they believe it protects their business continuity; as a result, they believe there is a realized return on investment. Conversely, those who view it as an expense do so because they see it as a necessary cost of doing business with no realized return.

All told, the findings regarding how risk management is viewed are as follows:

- 78 percent of financial executives and 93 percent of risk managers view risk management as an investment.
- 90 percent of respondents from companies with earnings greater than US$1 billion view risk management as an investment compared with 79 percent of smaller companies.

Risk management is an expense…

" Risk management is an expense because it is a cost of doing business and it is difficult to determine how much insurance premium savings are attributable to dollars spent on increased asset protection."

– *Risk manager*

" Risk management is an expense because it has no predictable return."

– *Chief financial officer*

Risk management is an investment…

" Risk management is an investment because you are investing capital to avoid potential future losses greater than the initial expenditure."

– *Risk manager*

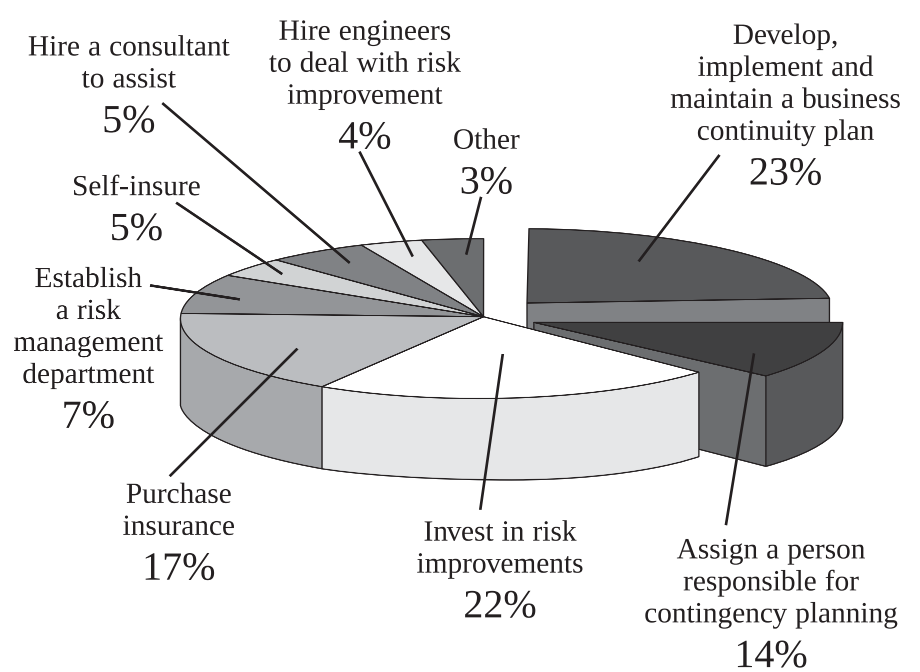
" Risk management is an investment because it is instrumental in protecting the future value of the company and mitigating exogenous events that could impact the ability of the company to generate a positive return to its shareholders."

– *Chief financial officer*

Is the Corporate World Willing to Spend More on Business Continuity Efforts?

Companies are looking beyond insurance to further enhance their risk management efforts. In particular, respondents indicated that more than one-third of any additional funding to protect one's top earnings drivers would be spent on business continuity (23 percent) and contingency planning (14 percent) efforts *(See Exhibit IX).*

Exhibit IX: Allocation of Additonal Funds to Protect Top Earnings Drivers



Respondents Favor Additional Property Insurance

On average, respondents indicated that, if given additional insurance dollars, they would allocate 26 percent to commercial property insurance. Specifically, risk managers would allocate 33 percent to commercial property insurance while financial executives would allocate 20 percent. This may imply that risk managers are not as comfortable as financial executives with their organization's commercial property insurance coverage *(See Exhibit X).*

Exhibit X: Budget Allocations by Insurance Line

Type of Insurance	2003 Financial Executives	2003 Risk Managers	2003 All Respondents
Commercial property	20%	33%	26%
General liability	19%	10%	15%
Excess liability	16%	10%	13%
Other	11%	10%	11%
Workers' compensation	8%	13%	10%
Directors' and Officers'	9%	7%	8%
Employee benefits	6%	9%	7%
Errors and omissions	8%	4%	6%
Automobile	3%	4%	4%

Conclusion

While financial executives and risk managers are in the business of balancing risk against return and trying to optimize that balance within their corporate risk tolerances, the results of the *2003 Protecting Value Study* show each has different perspectives on risk that have not changed fundamentally since September 11, 2001.

Much of the financial executive's world involves dealing with a broad portfolio of risks. The risk manager's world, in contrast, revolves around developing and implementing optimal risk aversion practices while adhering to budgetary constraints. As a result of these diverse realities, it is not surprising that there are differing views regarding such issues as top earnings drivers and hazards, resources for business continuity efforts and allocating insurance budgets.

Arguably, this may be a desirable state of affairs. As the study results indicate, risk management is a long-term proposition, and this requires sensitivity not only to internal risk management practices, but also to the broader realities of the global marketplace.

Given this delicate balance, there must be more communication between financial executives and risk managers regarding perceived threats and business continuity planning efforts in order to form a more strategic view of risk management. If this can be accomplished, companies should be able to effectively address the stable inventory of long-term risks, as well as the "threats-of-the-day" that command so much press attention.

The *2003 Protecting Value Study* serves as a benchmark that financial executives and risk managers can use to convey the importance of prudent risk management. The findings provide a framework for important discussions at the highest levels within an organization. Financial executives and risk managers may wish to take advantage of this opportunity, begin a dialogue and continue to protect the value their firms create.

Key Questions to Ask Yourself

- Have you explicitly identified the top earnings drivers for your company (i.e., how you create value)?
- Have you explicitly identified the top hazards associated with each top earnings driver (e.g., operational, personnel, financial, intellectual)?
- Has your risk-management function taken appropriate steps to address each top hazard (e.g., via risk transfer and/or contingency planning)?
- Have you communicated your risk management approach and actions, both internally to employees and externally (e.g., investment community)?
- To what extent is there alignment on risk management issues within your organization?

Research Methodology

The *2003 Protecting Value Study*, conducted by FM Global, Financial Executives Research Foundation, Inc., and the National Association of Corporate Treasurers, was targeted at financial executives (CFOs, treasurers) and risk managers of the world's top corporations. Respondents were recruited globally through the mail using both third-party and proprietary lists. They were directed to a Web site *(www.protectingvalue.com)* to complete the study.

Roughly two-thirds of the respondents were financial executives; the other one-third were risk managers. The respondents work for large firms—both domestic and international—from a wide variety of manufacturing, service and process industries.

The 2003 overall responses were weighted to the *2002 Protecting Value Study* results for comparability purposes.

Exhibit XI: Respondents by Title
(2002 Results in Parentheses)

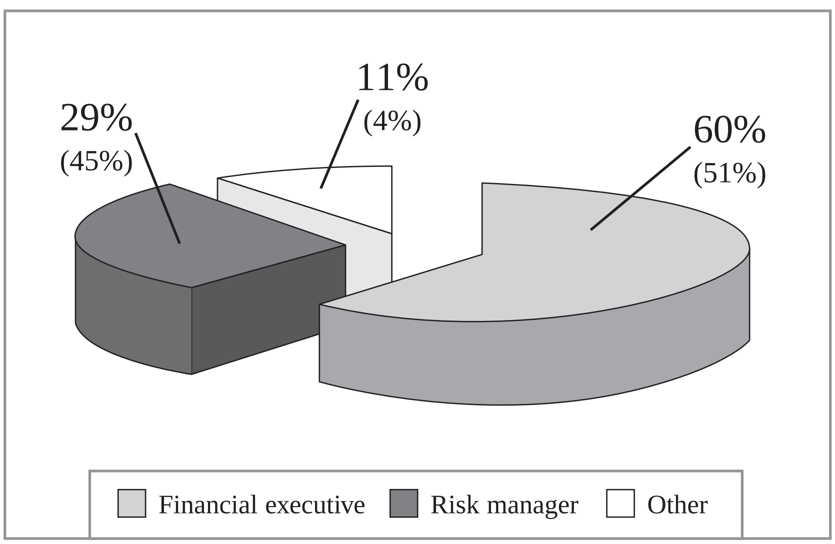


Exhibit XII: Respondents by Company Industry

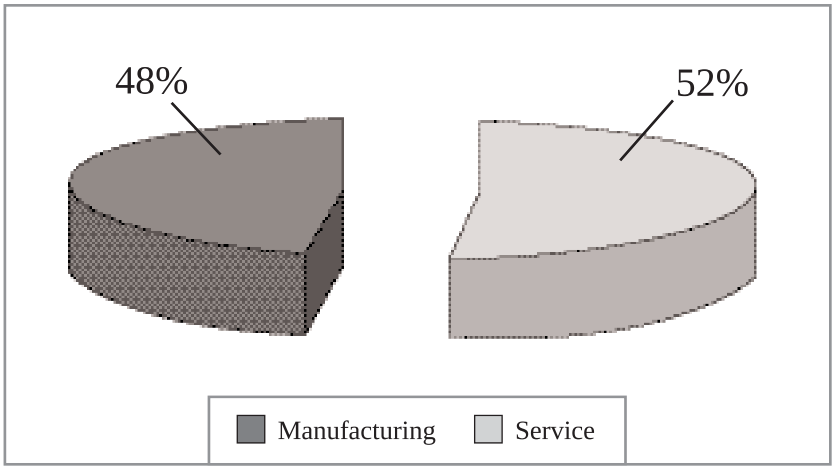
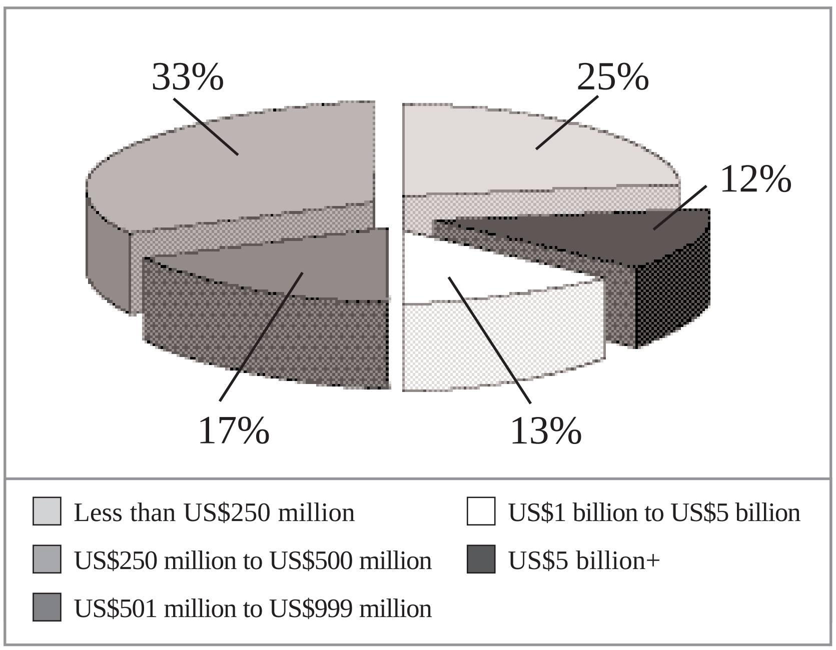


Exhibit XIII: Respondents' Company Revenue



Industry Categories

MANUFACTURING

Technology Manufacturing

Computers and Technology

Electronics

eMarketplace

Telecommunications/ ISPs

Non-Technology Manufacturing

Aerospace and Defense

Automotive

Consumer Goods

Fabricated Metal

Food

Furniture

Printing and Publishing

Textiles

Process Industries

Chemicals

Forest Products

Metals/Mining/ Natural Resources

Oil and Gas

Pharmaceuticals/ Biotech

Power Generation

Rubber and Plastics

SERVICE

Financial

Financial Services

Insurance

Real Estate

Trade

Retail Trade/ Distributor

Wholesale and Retail

Other

Business Services

Construction/ Engineering

Education

Health Care

Government/ Municipalities

Logistics/ Transportation

Media/Entertainment

Non-Profit

Utilities (distribution)

Additional Information

For an electronic copy of this executive summary, please visit *www.protectingvalue.com.*

For additional information on the *Protecting Value Study,* or to learn how to participate in the next study, please contact:

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About the Research Partners

FM Global is a mutual property insurance organization with a unique risk management focus. Its clients look to the company to help them maintain continuity in their business operations, develop cost-effective insurance and risk-financing solutions, and minimize the overall financial impact if a loss does occur.

FM Global meets these needs with customized programs that draw upon its state-of-the-art property loss prevention engineering and research, risk-assessment skills and support services, tailored risk transfer capabilities and superior financial strength.

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The National Association of Corporate Treasurers (NACT) is a professional association of treasurers from America's leading corporations of all sizes. Its purpose is to facilitate the exchange of information beneficial to the management of corporate treasury operations.

NACT facilitates dialogue between corporate treasurers and their colleagues, opening valuable opportunities and introducing new approaches and better solutions. Through focused, serious-minded programs and activities, NACT members share ideas on a wide spectrum of financial situations including negotiating for better terms; corporate investment opportunities to enhance income; benefits finance; risk management; insurance; large, medium and small company issues; and many more.

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