NACD Directorship

ERM: The Elephant In the Room

Boards are destined to underperform if they don't understand the risks they are asked to monitor.

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While enterprise risk management (ERM) is inextricably linked to audit committee functionality, it's too often overlooked that a board's ability to effectively identify, analyze, and manage risk is reliant upon the nominating committee first and foremost. That is, boards—especially boards of smaller public companies—will chronically underperform if directors are serially asked to monitor risks they don't understand.

Though seemingly self-evident, it's instructive that ERM scholarship rarely even mentions this fundamental tenet. For example, in Casualty Actuarial Society's seminal 2003 study *Overview of Risk Management* there is extensive discussion about culture, terminology, case studies, and even a section devoted to "Practical Considerations in Implementing ERM," yet there isn't a single reference to the backgrounds required to successfully manage risk in a given organization. Moreover, in COSO's *Effective Enterprise Risk Oversight—The Role of the Board of Directors (2009)*, despite pointing out that "[w]hile ERM is not a panacea for all the turmoil experienced in the markets in recent years, robust engagement by the board in enterprise risk oversight strengthens an organization's resilience to significant risk exposures[,]" nowhere in that presentation is there any mention of the paramount need for directors to possess contextual expertise.

Thankfully, though, the "elephant in the room" has been flagged by others of late. For example, writing on NACDonline.org, Henry Stoever stated: "To guide an organization through today's challenging business environment, the board must be comprised of directors with a wide range of skills and experiences." Mr. Stoever went on to write that: "A board that truly serves as a strategic asset to investors is one that brings together a team whose skill sets are aligned with the goals of the company."

Recruiting directors who are sufficiently expert with respect to material risks an enterprise could face should, among other things, form the basis for prudent nominating committee function in all size public companies. That said, it's arguably nowhere more important than in small-cap companies for three principal reasons: i) small-cap companies typically can't afford to have large boards so they must create more intellectual diversity with fewer directors; ii) unlike larger companies, small-cap companies typically can't afford to hire consulting firms to identify and analyze risks as to which the directors might not otherwise be conversant; and iii) small-cap companies have razor thin margins of error.

Given what's transpired in the last several years, shouldn't all ERM corporate governance scholarship start and finish with the elephant in the room?

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