Enterprise Risk Management: RAI’s Journey and Approach

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Vice President and General Auditor
Reynolds American Inc.

N.C. State ERM Roundtable Series
October 27, 2006
• Reynolds American (RAI) Overview
• Enterprise Risk Management Overview
• The Evolution of ERM at RAI
• RAI’s ERM Process
• Key Considerations and Next Steps
• Q&A
Reynolds American

- Created in 2004
- Same year that the U.S. operations of Brown & Williamson combined with RJR Tobacco
- HQ: Winston-Salem, N.C.
- About 8,000 employees
Reynolds American

- Operating companies:
  - R.J. Reynolds Tobacco Company
  - Conwood Company
  - Lane, Limited
  - Santa Fe Natural Tobacco Company, Inc.
  - R.J. Reynolds Global Products, Inc.

- Net Sales – $8.3 Billion
- Assets – $6.6 Billion
- Market Cap – $18+ billion
RAI’s vision:

Build a company that can deliver sustainable earnings growth
R.J. Reynolds Tobacco Company

- RAI’s Largest subsidiary
- 2nd largest U.S. cigarette company
- Five top-10 brands
Conwood Company

- Most Recent Acquisition
- HQ: Memphis, Tenn.
- No. 2 in smokeless tobacco
- Growth leader in moist snuff
Enterprise Risk Management (ERM)
Overview
The most recognized definition of ERM is provided by the COSO framework

- A process
- Effected by an entity’s board, management and personnel
- Applied in strategy setting
- Designed to identify potential events that may affect the entity
- Designed to manage risks to be within the company’s risk appetite
- Able to provide reasonable assurance regarding achievement of the entity objectives

As defined by COSO’s 2004 Enterprise Risk Management – Integrated Framework
Why Implement ERM?

External

- Evolving legal and regulatory developments
- Governance requirements
- Factor for ratings agencies
Why Implement ERM?

Internal

- Better decisions / improved business performance
  - Cross-company view of risks
  - Risk-aware culture
- Transparent communication among top management and Board
Informal Qualitative Discussions

Considerations:
- One size does \textbf{NOT} fit all
- \textit{Know your company’s needs and culture}
- \textit{Use consultants wisely}

Risk Management Approaches

Sophisticated Quantitative Modeling
ERM is an emerging practice

- Of 271 companies surveyed in North America and Europe:
  - Only 18% used most basic ERM elements
  - Only 16% integrated ERM into business practices, such as strategic planning or budgeting

Why Planning is Important
The Evolution of ERM at Reynolds American
Merger planning provided opportunity to investigate best practices at each company

- Integration risk
- Strategic risk
- Business process risk
During the integration risk assessment, RAI explored a comprehensive ERM approach

Needed to balance:
  - NYSE listing requirements
  - Regulatory developments
  - Consultant input on best practices

With:
  - Management’s concern of initiative overload
  - Fear of “SOX-like” complexity and bureaucracy
Leveraged existing processes into an “ERM Light” framework

- Launched in September 2005
- Right for RAI’s culture
- Pragmatic approach
- Substance vs. form
- Consultant expertise for “sanity check”
- Aligned with COSO
I think I found a corner piece.
Four-step process

1. Define strategies and success factors
2. Define Risk Universe
3. Define ongoing process
4. Align with COSO framework
Step One:

- Define strategies, objectives and critical success factors needed to achieve corporate mission
Step Two: Define the Risk Universe

- Compliance, Financial Reporting, and Fraud Risks
- Operational Risk
- Financial Performance Risk
- Marketing/Business Environment Risk
- Strategic Business Risk
Define the Risk Universe

- Business Model
- Brand Portfolio
- Life Cycle (Industry/Product Evolution)
- Opportunity/Business Concentration (JV, M&A, L/T Strategic Direction)
- Resource Allocation
- Organizational Culture and Structure
Define the Risk Universe

- **Industry Dynamics**
- **Trade/Channel Effectiveness**
- **Political**
- **Legal and Regulatory**
- **Technology – Innovation & Infrastructure**
- **Competitive**
- **Customer/Consumer Wants**
- **Program Design**

Strategic Business Risk

Marketing/Business Environment Risk

Financial Performance Risk

Operational Risk

Compliance, Financial Reporting, and Fraud Risks
Define the Risk Universe

- Product Pricing
- Cost Structure
- Interest Rate/Currency Fluctuation
- Capital Availability
- Funding/Liquidity
- Credit Risk
- Equity Risk
- Concentration Risk
- Shareholder Relations
- Trademark/Brand Name Erosion
- Catastrophic Loss

Compliance, Financial Reporting, and Fraud Risks

Operational Risk

Financial Performance Risk

Strategic Business Risk
Define the Risk Universe

- Product Failure
- Health, Safety and Environmental
- Sourcing
- Human Resources
- Product Development
- Capacity
- Customer / Consumer Satisfaction
- Supply Chain
- Execution
- Information Processing / Technology Risks
- Measurement & Business Reporting Risk

Compliance, Financial Reporting, and Fraud Risks
Define the Risk Universe

- Legal and Regulatory Compliance
- Financial Accounting, Budgeting and Reporting
- Taxation Risk
- Pension Fund/Health Care Risk
- Integrity Risk

Compliance, Financial Reporting, and Fraud Risks
Step Three:
Define an Ongoing Dynamic Process

1. Strategic Risk Assessment
2. Annual Operating Plan
3. Business Process Risk Assessment
4. Annual Audit Plan
5. Topline Update of Strategic Risks
RAI’s process addressed each component of the COSO framework

COSO = Committee of Sponsoring Organizations
RAI’s ERM Process
Strategic Risk Assessment

1. Strategic Risk Assessment: Deep Dive
   - June – August timeframe
   - Top 25 – 30 strategic risks
   - Gap identification and remediation

2. Annual Operating Plan

3. Business Process Risk Assessment

4. Annual Audit Plan

5. Topline Update of Strategic Risks
Who is involved?

Process Leaders:

- SVP Strategy & Planning
- VP and General Auditor

Risk Owners:

- Functional Leadership

Oversight:

- RAI Leadership Team
- Audit Committee (review role only)
Deep Dive Process

What is involved?

▪ Identify strategies
▪ Identify threats
▪ Quantify risks
  – Likelihood
  – Impact
▪ Identify gaps
▪ Report
## What tools are used?

<table>
<thead>
<tr>
<th>Risk Description</th>
<th>Operational</th>
<th>Owner:</th>
</tr>
</thead>
<tbody>
<tr>
<td>RAI is unable to attract, retain and engage key leadership and top talent necessary to create a high performance culture.</td>
<td></td>
<td></td>
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</tbody>
</table>

### Contributing Factors/Risk Drivers | Risk Assumption
--- | ---
Social pressures/negative outlook for industry | Business productivity goals not achieved
Financial reward structure does not engage employees | |
Loss of institutional knowledge and talent (employee demographics) | |
Failure to imbue succession planning and development in the culture | |
Superior long-term opportunities elsewhere | |


<table>
<thead>
<tr>
<th>Volume:</th>
<th>Earnings:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
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</tbody>
</table>

### Existing Risk Management Activities (actions taken to ensure success)
- Rigorous talent development program
- Leadership classes
- Clear communication of strategic vision and values
- Competitive financial rewards
- Adherence to Continuous Productivity Initiatives planning process, succession plans, intolerance of poor performance
- Diversity

### Risk Indicator Metrics | Gaps/Recommended Additional Risk Mitigation Activities
--- | ---
Denison Survey | None
Union campaign | |
Attrition | |
Productivity milestones | |
Inability to recruit top talent | |

<table>
<thead>
<tr>
<th>Risk Rating</th>
<th>Estimated Cost of Mitigation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inherent Risk</td>
<td>Mgmt. Effectiveness Rating</td>
</tr>
<tr>
<td>Likelihood (1-5)</td>
<td>Low (&lt;$5mm)</td>
</tr>
<tr>
<td>Impact (1-5)</td>
<td>Medium ($5mm - $10mm)</td>
</tr>
<tr>
<td>Exposure (LxR)</td>
<td>High (&gt;-$10mm)</td>
</tr>
</tbody>
</table>
How are risks quantified?

Likelihood Rankings
(5 year horizon)

<table>
<thead>
<tr>
<th>Rating</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Remote (&lt;5%)</td>
</tr>
<tr>
<td>2</td>
<td>Unlikely (6% - 25%)</td>
</tr>
<tr>
<td>3</td>
<td>Less than Likely (26% - 49%)</td>
</tr>
<tr>
<td>4</td>
<td>More than Likely (50% - 74%)</td>
</tr>
<tr>
<td>5</td>
<td>Probable (&gt;75%)</td>
</tr>
</tbody>
</table>
# How are risks quantified?

## Impact Rankings (5 year horizon)

<table>
<thead>
<tr>
<th>Rating</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>&lt;10 mm</td>
</tr>
<tr>
<td>2</td>
<td>$10 mm - $50 mm</td>
</tr>
<tr>
<td>3</td>
<td>$50 mm - $150 mm</td>
</tr>
<tr>
<td>4</td>
<td>&gt;$150 mm (Quantify)</td>
</tr>
<tr>
<td>5</td>
<td>Threatens business continuity</td>
</tr>
</tbody>
</table>
How a Risk Profile Matrix Works

Potential Impact of Risk

Likelihood of Occurrence of Risk

Key Focus Area
- **Ensure actions** are in place to mitigate the risk
- **Develop plans** to allow a quicker recovery
- **Monitor progress** of action plans

Monitor to ensure that risk profile does not increase and that cost of mitigation is not excessive

Monitor changes to risks and evaluate implications
For Example

Ensure actions are in place to mitigate risk; monitor at the highest level of senior management; provide comprehensive full Board updates.

Monitor to ensure that risk profile does not increase and that cost of mitigation is not excessive.

Ensure actions are in place to mitigate risk, monitor changes to risks and evaluate implications.

Impact (Millions)

Likelihood (%)
Annual Operating Plan

1. Strategic Risk Assessment
   - September – October timeframe

2. Annual Operating Plan
   - Topline Update of Strategic Risks

3. Business Process Risk Assessment

4. Annual Audit Plan
Business Process Risk Assessment

- October – December timeframe
- Map risks to business processes and activities
Strategic Business Objectives:
- Objective A
- Objective B

1. The business processes listed below are aligned by Critical Success Factors for this area. The Critical Success Factor is the component that drives success in the Corporate Strategic Business Objectives listed above. The function who owned the process in the 2005 Business Process Risk Assessment will be listed next to each process. Please assess the risk associated with each business process/mitigating activity as to likelihood and impact, using the definitions below.

2. Please feel free to add/delete/clarify the business process or change the function which supports that process.

<table>
<thead>
<tr>
<th></th>
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<tbody>
<tr>
<td>Critical Success Factor: Succession Planning Coverage</td>
<td>Strategic (S), Financial (F), Operational (O), Legal &amp; Regulatory (L), or Marketplace Success (M)</td>
<td>HR</td>
<td>L, M, H</td>
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</tr>
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Rigorous talent development program
Leadership class development

Types of Risk include: Strategic (S), Financial (F), Operational (O), Legal & Regulatory (L), or Marketplace Success (M)
## How are risks quantified?

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<th>Likelihood</th>
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How are risks quantified?

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<th>High</th>
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<tbody>
<tr>
<td>Low</td>
<td>&lt;$15mm</td>
<td>$16mm - $74mm</td>
<td>&gt;$75mm</td>
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Annual Audit Plan

• January timeframe
• Risk driven plan based on risk universe and results of risk assessment activities
• Assurance on highest risk areas

Strategic Risk Assessment

1

Topline Update of Strategic Risks

5

Annual Operating Plan

2

Business Process Risk Assessment

3
Quarterly Update of Strategic Risks

- Topline recap
- Assess changes to key risks/new risks
- Monitor progress against mitigation strategies
Key Considerations and Next Steps
Reynolds American has used an evolutionary ERM approach to create a comprehensive risk management program that conforms very well to RAI’s business needs and its culture.
A number of factors contributed to the success of RAI’s entry into ERM

- Supported by top leadership / CEO
- Based on extensive research / best practices
- Leveraged existing processes
- Minimized bureaucracy and number crunching
- Used consultant as a “sanity check”
Next step on RAI’s ERM journey:

• Better “emerging risk” identification
Thank you!

Q & A