To Our Readers

Risk Management and corporate governance go hand in hand. A number of surveys have been conducted on these issues in the recent past, and almost all have concluded that financial institution governance practices need improvement in part because most institutions equate effective governance with meeting the demands of regulators and legislators. That is, they tend to look at this as another compliance exercise. Most corporates and Banks tend to ignore the fact that this mindset of compliance does not allow them to reap strategic benefits from good governance.

Corporate strategies are directed towards the future. One of the more common shortcomings is focusing the strategy itself too much on market and financial results without giving adequate attention to the infrastructure necessary to support and sustain the strategy. This infrastructure is not merely plant and machinery. The infrastructure that we are talking about is a *governance* infrastructure which looks at risk-management and internal control environment – to talk about only two aspects- and which integrates these with the governance process and the strategic-planning exercise as a whole.

An essential part of an effective internal controls program is the individual who is in charge. One may have a well laid out and sound system, but if the individual running it has an incomplete understanding of how the control helps to mitigate risk exposures or fails to assume full responsibility for the operation of the control, or misinterprets the operating effectiveness of the control, then the result is an ineffective overall system.

Many of these surveys note that it is very difficult for outsiders to determine the effectiveness of corporate governance. Unfortunately, it takes real time disasters in internal controls for the public to become aware of weaknesses in the process. Normally, for obvious reasons disclosures by banks and corporates gloss over deficient governance or business practices, for the simple reason that these are likely to lead to lower share prices, lawsuits and lower credibility in the market place. The magnitude of the detrimental impact that can result from a serious breach in governance puts the costs of improved governance in perspective.

Let us look at the Regulators' perspective. Regulators typically measure effectiveness by some sort of examination assessment. Examination findings routinely cite ways in which risk management, including corporate governance, could be improved. However, it is also true that the senior management in Banks and corporates routinely focus on high-risk and emerging-risk areas within their organizations while continuing to provide appropriate oversight to the low-risk areas. Banks especially, take care to have effective internal audit and concurrent audit checks in place.

However, all is not, as one would say, well in the State of Denmark. Especially in the case of the smaller banks, including cooperative banks, major challenges remain poor asset quality and corporate governance issues, such as policies, planning, management, audits, controls, and systems. Recent failures have sufficiently highlighted these matters.

Obviously, poor asset quality and ineffective corporate governance are not mutually exclusive. When we find significant asset-quality problems, we usually find corporate governance problems—particularly inadequate internal controls. Similarly, when we find significant control deficiencies, significant asset-quality or financial-reporting problems are generally present. So what is the message we should take away from these statistics?

Saying that Governance is weak, does not solve the problem of how to bring in better governance. Undeniably, there is a (global) shortage of the right kind of people. This is where the role of accounting and auditing institutions comes into focus. Much more needs to be done to produce the right kind of people with the right kind of skills, and much more needs to be done by the Corporates and Banks themselves to imbibe better governance practices. We are talking about India Inc. here and its future credibility will certainly depend upon how well this particular issue is tackled.

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