Corporate Governance, Risk Management & Internal Audit

Narendra M. Apte

Corporate Governance and Risk Management have a special relationship. This article attempts to explore that relationship and discusses two issues — How risk management and internal audit can be integrated to ensure a high standard of corporate governance, and whether the disclosure, in its Annual Report, of information about risks faced by a company and the management of risks is adequate.

To begin with it would be appropriate to note definitions of the two terms, 'Corporate governance' and 'Risk management'. Organization for Economic Co-operation & Development defines 'Corporate Governance' as a 'set of relationship between company's management, its Board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are determined. Good corporate governance should provide proper incentives for the Board and management to pursue objectives that are in the interest of the company and its shareholders/ stakeholders and should facilitate effective monitoring, thereby encouraging firms to **use resources more effectively**. 'Risk management', on the other hand, is defined as the identification, analysis and economic control of all such risks that may **threaten assets, resources, or earning capacity of a firm/company.**

Risk management is in reality 'an all business activities embracing' tool and with a high standard of risk management, it would naturally be possible to ensure high standard of corporate governance. The close relationship between corporate governance and risk management can thus be easily understood.

Two broad categories of risks that the professional risk management deals with are:

Business Risks and (b) Pure or Insurable risks.

Ordinarily, internal auditor does not get involved in any decision making process. It is felt that in case of risk management it would be prudent for the internal auditor to have a say. The internal audit should ensure that risk management practices adopted by the concerned departments are adequate, considering the nature of various risks and their likely impact on the business operations of the company.

In a large company, different departments, depending on the nature of risk involved, may handle the risk management function. It

The author is a Member of the Institute. He can be reached at narenapte@vsnl.net

would, therefore, be necessary for the internal auditor to first get a fair idea of various categories of risks and action to be taken to confirm that enough safeguards are in place for managing different risks.

Financial Risks

If the internal auditor has to report on how the financial risks are being managed, he would consider the impact of following sub-categories of financial risks:

- **Market risks:** Under this sub-category foreign exchange risk, interest risk, commodity risk and equity risks are considered.
- Liquidity risk
- Credit risk
- Economic risk arising out of changes in economic structure
- Sovereign risk: failure of a government company/corporation or a State government to honour its loan obligations or other commitments

While examining the financial risks, the internal auditor has to pay special attention to the following points:

- ***Receivables and bad/doubtful debts*:** This is one significant item, which has to form part of the internal auditor's report, as in many companies financial crisis starts with a poor control on this item. It has a direct bearing on the financial health of many companies, particularly those companies with a very large number of customers, like telecom companies, electricity companies.
- ***Inventories:*** Optimum Inventory levels are decided by the Production and other concerned departments but it is the internal auditor who can ensure that the inventory carrying cost is properly controlled and is optimum.
- ***Investments***: The risk arising out of changes in interest rate policies of the Central Government /Reserve Bank of India can be quite substantial and has to be assessed at regular intervals because such changes result in substantial erosion of investments as in Debt schemes of Mutual Funds, etc.
- ***Foreign exchange transactions:*** The risk of financial loss on account of depreciation of foreign exchange bank balances or receivables has to be critically examined for reporting to the Board.

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Strategic Risk

This risk arises out of wider aspects of a company's activities, e.g., risk arising due to poor marketing strategy/acquisitions strategy, changes in consumer behaviour, poor product launches. From the point of corporate governance, management of strategic risks may be considered to be responsibility of the senior management/Board of Directors. In such a scenario, the internal auditor may not be entrusted with the responsibility of any critical examination of the risk management process.

Other Risks:

In case of other risks like environmental, technological and operational risks the internal auditor may not have an expert knowledge of the severity of the risks and he would have to take help of the concerned Departmental heads to critically examine the process of the risk management.

Insurable or Pure Risks

In this case, one major issue that the internal auditor may be required to examine could be adequacy of the insurance cover and the cost of such cover. For this purpose he would have to examine the past experience about insurance claims, loss prevention and safety measures, and, of course, the risk profile of various assets. In view of the increased competition between the general insurance companies, both in the public and private sectors, it has become possible to obtain a mega

policy cover and the internal auditor may be the right authority to critically examine all aspects regarding the insurance cover obtained for all risks of a company.

It would be necessary for the internal auditor to weigh impact of all these risks on the financial performance of the company and make a suitable quarterly report to the Board of Directors/CEO/MD of the company. This report could be submitted when the Board considers the Quarterly performance of the company.

Mr.Prakash A. Shimpi, in a book edited by him, gives a very useful and illustrative list of various risks faced by companies operating in different industries like Telecommunication, drug manufacturing/pharmaceutical and airlines. **Obviously the same risk management techniques will not work in all situations and to that extent it makes the job of corporate governance vis-à-vis risk management more complex and challenging.**

In large companies, very often, different departments manage different type of risks. It, therefore, becomes essential to ensure proper co-ordination between the various departments managing risks. An integrated approach to risk management is hence recommended to ensure better management and better results.

Audit Committees have a significant role to play in ensuring proper co-ordination between different departments managing different risks.

Many big companies have already recognized the role of the Audit Committee in regard to risk management and there is a growing realization that integration of all risk management functions can deliver better results if the audit committee can provide the necessary guidance.

Disclosure practices

As per the Listing Agreement, the Audit Committee of a listed company has to review risk management policies of the company.

It is reasonable to expect that the corporate governance report covers the areas of existing or potential risks to the business of the company and briefly outlines the Board's perception of such risks and action taken by the company.

When we examined Annual reports of leading companies for the year 2003-04 we observed that although a growing number of companies have started disclosing their risks, the level of disclosure differs as also the content.

Since standard of risk management practices has a direct influence on the financial health of the company, it is felt that the level of disclosure in the Annual report in this regard should be specified in the Listing Agreement itself. Obviously it would require a change in the Listing Agreement but time has come for making appropriate reforms in this important governance indicator.

In the following paragraphs we look at disclosure in annual reports of companies operating in different sectors of our economy.

- In the Corporate Governance Report (CGR) of ***Raymond Ltd.,*** for the year ended 2003-04, there is only a passing reference to terms of the Audit Committee of the company which included, *inter-alia,* 'reviewing the adequacy of internal control systems, and internal audit function, ensuring compliance of internal control systems and reviewing the Company's financial and ***risk management policies'***.
- In the CGR of ***Tata Steel Ltd***., also for the year 2003-04, it is recognized that "Risk is inherent in business activity, particularly in the steel industry. The report says that the Company has processes in place to identify warning signals at an early stage to hedge itself against potential threats. On the other hand, it explains, these processes enable early recognition of opportunities emerging in the business environment.' The Tata Steel CGR also highlights certain important facts, e.g., "the steel industry displays strong commodity characteristics and is subject to cyclical price movements in business cycles. The Company has sought to mitigate the impact of this commodity characteristic of the steel industry in its focus

markets and it has achieved some measure of success in its endeavour". 'On the production front, the report says, "development of value added products has significantly enriched the product mix, which is less susceptible to price cycles. The Company follows prudent financial practices. It is considered opinion of Management that is has taken all possible steps to maintain and enhance the competitive position of the Company."

In the Annual Report of ***Infosys Technologies Ltd***. for the year 2003-04, there is a separate, comprehensive 'Risk Management Report' (RMR). The RMR provides details of all key risks faced by the Company and steps taken by the Company to manage those risks. In a way this RMR is a model for all companies to follow. It will not be out of place to note here the External and Internal Risk factors, vis-à-vis the Business objectives of the Company, enumerated in the RMR of Infosys Technologies:

In the annual report of ***Tata Motors Ltd***., risks and concerns of the Company have been classified under four heads: (a) risk arising out of increase in input costs, (b) risk arising out of increase in fuel prices, (c) risk arising due to exchange fluctuations, and (d) risk arising out of acquisition of a car company in South Korea. Impact of the above risks on the profitability of the Company has been mentioned in the report.

In the annual report of ***Tata Power Ltd.,*** risk management has been dealt with separately. Major risks faced by the Company have been mentioned as (a) risk on account of electricity tariff regime changes, (b) risk on account of reducing availability of gas for Trombay Thermal Power Station of the Company, (c) risk on account of increase in price of feed material, (d) risk of financial liability on account of major legal case with a competitor, (e) risk to proposed power projects on account of adverse changes in Government policies/regulations in the power sector and risks associated with development/construction, and (f) a risk associated with the telecom business wherein the Company has significant investments.

Suggestions for better disclosure

Since standard of risk management practices has a direct influence on the financial health of the company, it is felt that the level of disclosure in the Annual report in this regard should be specified in the Listing Agreement itself. Obviously it would require a change in the Listing Agreement but time has come for making appropriate reforms in this important governance indicator. It is felt that standard of disclosure of the level of Infosys Technologies Ltd., though ideal, may not be immediately achievable. However, even if companies are given time of say three years to achieve, it would mean a new beginning, something to be happy about. ■

Business Objectives	External Risk Factors	Internal Risk Factors
Financial performance Achieve revenue growth Sustain profitability Increase revenue productivity **Client and market focus** Grow client relationships Differentiate client offerings Broaden geographical footprint **Execution excellence** Leverage Global Delivery Model Control operational costs Improve quality &productivity **Organizational development** Develop and retain competencies Develop global workforce Develop 3 tiers of leadership	Macro economic factors Exchange rate fluctuations Political environment Competitive environment Concentration of revenues inflation and cost structure Immigration regulations Security and business continuity Technology obsolescence 	Financial reporting risks Liquidity and leverage Contractual compliance. Compliance with local laws intellectual property management. Engagement execution Integration of subsidiaries Human resource management Culture, values and leadership.