Enterprise Governance and Risk Management

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< EXECUTIVE SUMMARY >

◆Beyond Corporate Governance, organisations also need to look at their enterprise governance and IT governance activities. A good governance framework pays big dividends in the long run. Following sound risk management, governance and disclosure practice consistently is crucial in maintaining the confidence of capital and financial markets.

The Board of Directors and executive management are responsible for ensuring that, both Corporate Governance Process and Performance Management Process are conducted with competence and integrity.

CHANGING TIMES

Corporate Governance is being considered the ruling mantra by stakeholders and managers since last decade. Even in third world countries where things does not seem to move very fast, corporates and their shareholders are doing everything in their control to implement the practices of Corporate Governance.

But now a days managers all over the Globe have realised that mere Corporate Governance is not sufficient to safeguard the interests of enterprise and its stakeholders. Both boards and senior management continue to face new and increasingly complex business challenges-mergers and acquisitions, advances in technology and the demands of conducting business in a global economy, among many others. Particularly in India, the shift from a controlled economy to an open economy has increased the potential for risks and, also the commensurate rewards. This paradigm shift has put on the Board of Companies an onerous responsibility of managing with requisite skills and a degree of caution, the risks thrown by the internal and external environment. Consequently, the once impervious boardroom has become increasingly subject to shareholder activism and rigorous regulatory scrutiny. Today's directors and officers face rapidly evolving standards and corresponding new liability risks-in their pursuit of improved corporate performance. In this changing scenario, every professional is realizing that mere 'Conformance' (read Corporate Governance) would not help them in achieving their roles but it is 'Performance'(read Business Governance) which is also a major contributing factor.

Chartered Accountants can play a critical role in evolving a holistic approach, which embodies not only good corporate governance but also effective performance management. This explains the growing international shift from mere Corporate Governance to Enterprise Governance.

Corporate governance can be complex. It is the relationship among various participants-shareholders, management and the board of directors-who work in concert to determine the direction and performance of corpora-

The author is member of the Institute. The views expressed herein are the personal views of the author and do not necessarily represent the views of the Institute.

tions. The accepted governance framework is simple: management is accountable to the board, and the board is accountable to the shareholders. For the past 10 years, this framework, particularly the board's role, has been evolving. The board does more than mechanically link those who manage the corporation and those who own it. As a surrogate for dispersed ownership, in fact, the board is at the centre of corporate governance itself, working aggressively and independently on behalf of shareholders and, in some circumstances, other constituencies.

Internationally there is now an increasing momentum towards constituting more laws and government regulations that impose obligations on companies, their directors and officers, to adopt, implement and comply with good corporate governance. Failure to do so may lead to legal and criminal sanctions being imposed on the company, its directors and officers.

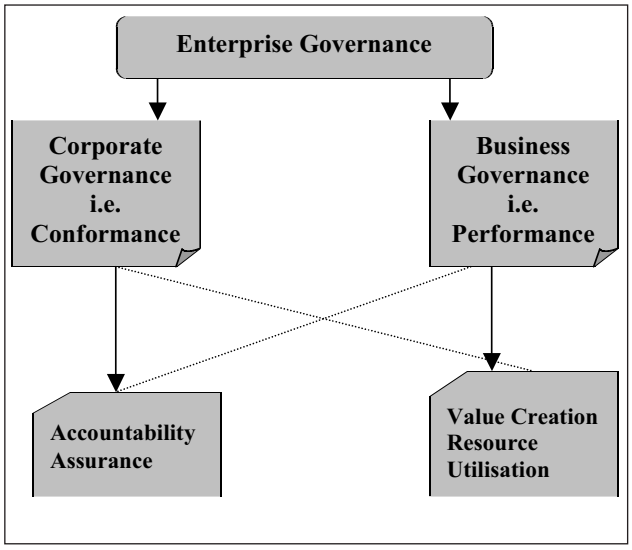
The quality of governance is of absolute importance to various stakeholders including shareholders as it provides them with a level of assurance that the business of the company is being conducted in a manner that adds shareholder value and safeguards its assets. If a company adopts and implements good governance practices, shareholders are retained and new investors attracted. Opinion surveys have revealed that institutional investors have indicated a willingness to pay a premium for the shares of a well-governed company.

ENTERPRISE GOVERNANCE

Enterprise Governance is the Accountability Framework

Like the term "freedom", enterprise governance is a concept that is understood generally, there being no formal body charged with its definition and promotion. Therefore, this discussion of enterprise governance is based solely on the interpretation of the author. Enterprise governance is the accountability framework for all management processes. This framework is designed (explicitly or implicitly) by the executive team under the auspices of the board of directors. Together, they strive to optimize use of resources by aligning all the activities of the organization in order to clarify and execute strategic and operational direction as well as attitude toward risk.

Information System Audit and Control Foundation defines enterprise governance as 'The set of responsibil-

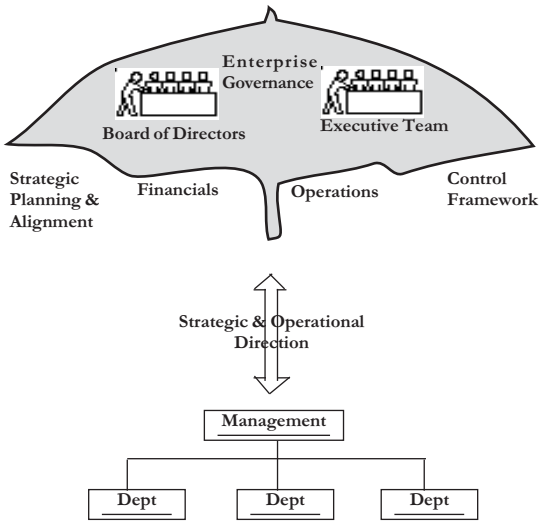


ities and practices exercised by the Board and the executive management with the goal of providing strategic direction, ensuring that objectives are achieved, ascertaining that risks are managed appropriately and verifying that the organisation's resources are used responsibly.' In nutshell enterprise governance also addresses the performance management aspects with emphasis on strategy and forward direction. The whole objective behind adopting enterprise governance practices is to install a system and process by which entities are directed and controlled to enhance performance and sustain shareholder value. It concerns the effectiveness of management structures (including the role of directors), the sufficiency and reliability of corporate reporting, and the effectiveness of risk management systems.

A global standard of "good enterprise governance" is still developing, and includes:

- Independent monitoring of management.
- Transparency on corporate performance, ownership and control.
- Participation in fundamental decisions by shareholders.
- Company compliance with relevant laws and regulations.
- A board of directors with the information and independence to assure compliance with these standards.
- Strategic Planning and alignment.
- Strategic Decision Making.
- Strategic Risk Management.
- Scorecards.
- Strategic Enterprise systems.
- Continuous Improvement.

—Enterprise Governance



KEY ENTERPRISE GOVERNANCE PROCESSES

- **Strategic Planning & Alignment**
  - Integrated strategic planning
  - Performance tracking
  - Value alignment
  - Market analysis
  - Enterprise initiatives
  - Stakeholder relations
- **Operations**
  - Business operations (e.g., manufacturing, retail)
  - Facilities
  - Human resources
  - IT systems and processes
  - Data, records and knowledge management
  - Communications and documentation
- **Financial Management**
  - Financial reporting
  - Debt and cash flow management
  - Asset management
  - Budget
- **Internal Controls**
  - Corporate governance
  - Risk management
  - Audit (financial, operational and IT governance)
  - Quality control
  - Security
  - Legal

Source: Shamrock Technologies

During the recent past, the issue of enterprise governance has been dominated by reactions to three major events: the collapse of Enron and the crash of other high-profile financial restatements; new risk perceptions due to the tragic events of 9/11; and the economic downturn and its impact on financial reporting.

Each of these events has resulted in significant shareholder interest in enterprise governance and how it might be improved to minimise similar risks in their companies. Boards are under increasing pressure to become more accountable, transparent and responsive to stakeholders.

RISK MANAGEMENT

At the very heart of enterprise governance is risk management. This comprises the design, implementation and monitoring of the process of risk management and ensuring that it is integrated into the day to day activities of the company. It is the responsibility of the Board of Directors of a company to:

- Set the risk strategy policies in liaison with management;
- Ensure that the company has implemented an effective ongoing process to identify risk and its potential impact on the business of the company;
- Activate what is necessary to proactively manage these risks;
- Maintain a sound system of internal control to safeguard shareholders investment, the company's assets and the company's ongoing sustainability;
- Make disclosures to shareholders on the company's risk and management thereof.

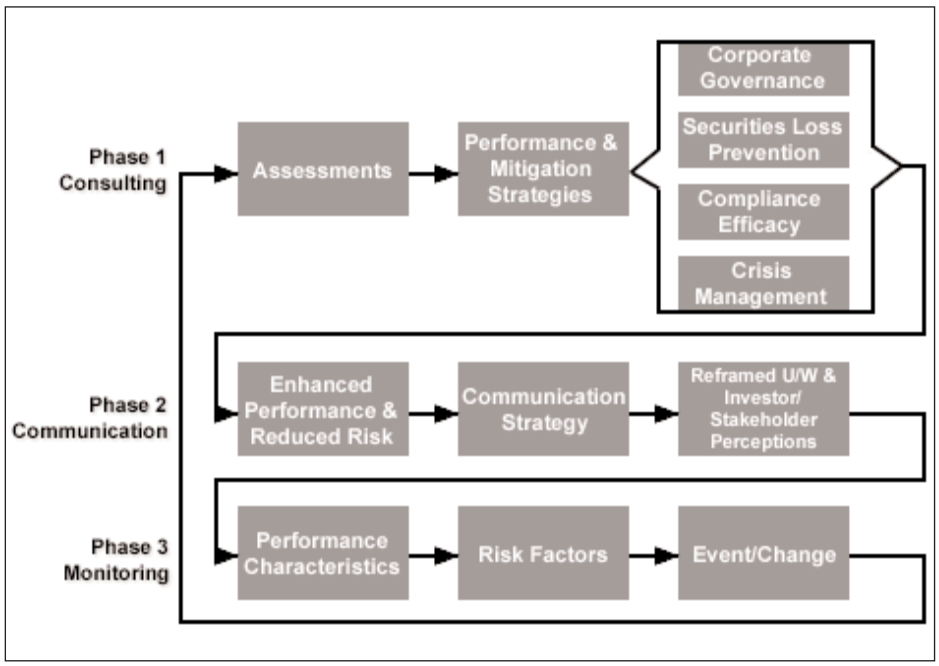
Risk management is an essential tool of good management practice and governance. It is the process whereby there is shared awareness and understanding within the organisation of:

- The nature and extent of the risks it faces;
- The extent and categories of risks regarded as acceptable;
- The likelihood and potential impact of the risks materialising;
- Its ability to reduce the incidence and impact on the organisation of risks that do materialise.

The process involves:

I. Regular and ongoing monitoring and reporting of risk including early warning mechanisms;

II. Appropriate assessment of the cost of operating



particular controls relative to the benefit obtained in managing the related risk;

III. Atleast annually, a review of the effectiveness of the systems of internal control in place;

IV. Reporting the results of the review, and explaining the action being taken to address any significant concerns that are identified.

To illustrate how performance and risk are inextricably linked, J&H Marsh & McLennan developed "the Process Model" to show a highly focussed approach towards integrating both perspectives. Although the overall process is sequential in design, companies can start from any point, depending on their own developmental stage.

RISK ASSESSMENT

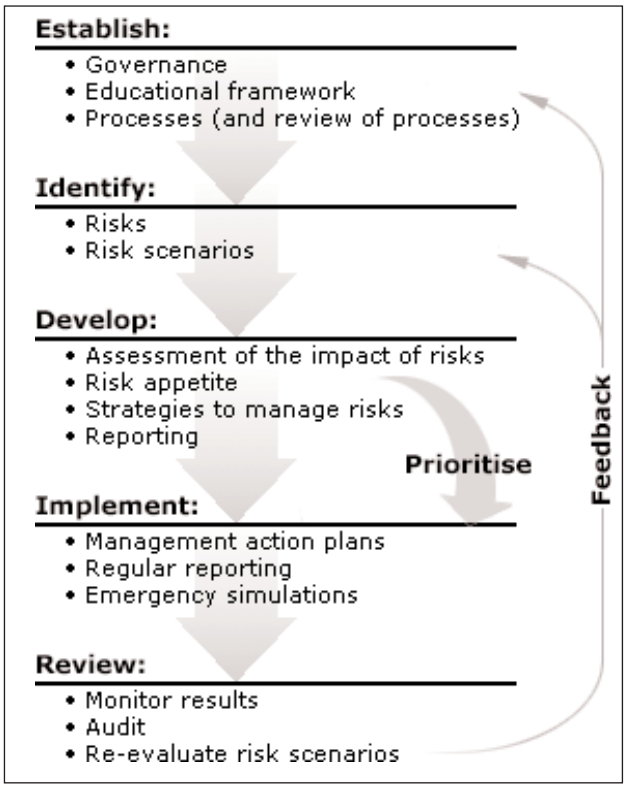
As corporations grow larger and more diverse, it becomes more difficult for executive management and Boards of Directors to monitor activity across the company. Directors, particularly, do not have the time to understand all of the transactions occurring. Thus, a key issue for boards and audit committees is how to focus their attention to the appropriate areas. This is where a sound risk management and internal control framework can be very helpful.

Also, the Sarbanes-Oxley Act (SOX) requires management to issue a report about the quality of internal controls. A similar requirement was put into effect for banks in the Federal Deposit Insurance Corporation Improvement Act of 1991. Since then, bankers have adopted approaches along the lines of the Committee of Sponsoring Organizations' of the Treadway Commission (COSO) Internal Control--Integrated Framework. This requires all managers, at least once a year, to step back from other duties, and evaluate risks and controls. Each manager considers current and planned operational changes, identifies the risks, and determines appropriate mitigating controls and the effectiveness of those controls. Managers then report their assessment up the chain of command to the chief executive officer, with each new level of management in turn considering the risks and controls under their responsibility. The external auditors attest to the results of this self-assessment and results are reported to the audit committee of the Board of Directors. Thus, the process helps the management communicate among themselves and with the board about the dynamic issues

affecting risk exposures, risk appetites, and risk controls throughout the corporation.

Risk assessments such as the one outlined in COSO's internal control framework presumably could be useful in assessing the relative risk and returns from various lines of business when formulating business strategies. But not all corporations and boards consider

Risk management framework



risk as a part of their annual strategic planning or other evaluation processes.

A study conducted this year by the Institute of Internal Auditors and the National Association of Corporate Directors showed that directors are not focusing on risk management. 45 percent of directors surveyed said their organization did not have a formal enterprise risk management process -- or any other formal method of identifying risk. An additional 19 percent said that they were not sure whether their company had a formal process for identifying risks.

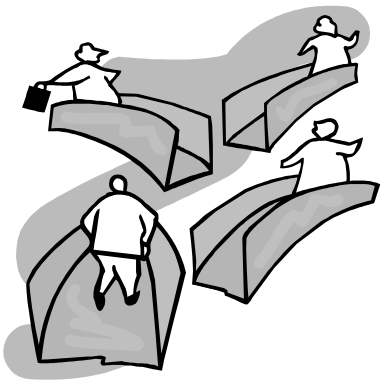
Sound enterprise governance is an essential element of a strong risk management process. Governance involves many players, each with specific assigned responsibilities to ensure that the system as a whole is sufficient to support the business strategy and ensure the effectiveness of the systems of internal control.

Directors are not expected to understand every nuance of every line of business or to oversee every transaction. They can look to management for that. They do, however, have the responsibility to set the tone regarding their corporations' risk-taking and to oversee the internal control processes so that they can reasonably expect that their directives will be followed. They also have the responsibility to hire individuals who they believe have integrity and can exercise a high level of judgment and competence. In the light of recent events, I would like to say that directors have the further responsibility to periodically determine whether their initial assessment of management's integrity was correct.

Indeed, beyond legal requirements, Boards of Directors and Managers of all firms should periodically test where they stand on ethical business practices. They should ask, for example, "Are we getting by on technicalities, adhering to the letter but not the spirit of the law? Are we compensating ourselves and others on the basis of contribution, or are we taking advantage of our positions?"

INTEGRATING RISK MANAGEMENT WITH ENTERPRISE GOVERNANCE

The generalised move towards enterprise governance is, in essence, an effort to manage risk in a better manner. Many companies and individuals have lost a lot of money or have otherwise been hurt in recent corporate 'incidents'. As a result, the public has begun to demand detailed and regular information on the risks faced by companies and how they manage it.



In addition to this, the expectations of society from 'good' companies has undergone a sea change. Twenty five years ago, a company's market value would correspond to figures, as they appeared on the balance sheet. Today, a company's balance sheet accounts for merely 25 percent of market value. There is no way to measure the remaining 75 percent that is captured in intangible assets, such as brands, reputation, and relations with customers, employees, and suppliers. The public is hence, placing a premium on good corporate citizenship and governance.

In the move towards better enterprise governance and risk-management systems, companies are trying to determine which are the pertinent risks and how can they

be prioritised. Experience reveals that every manager in a company has his own perception of key risks. The prime challenge is, therefore, to find a way to translate an array of risks into a common concern.

Most importantly, companies will have to learn to manage risks in an integrated way. While in the past, risks were managed individually they now have to be managed as a portfolio. This requires a clear understanding of which risks reinforce/compensate each other etc. The portfolio will have to be constantly balanced and re-balanced in order to reduce the company's overall risk profile.

In the US, many companies have created a specific job profile of a Chief Risk Officer (CRO). As an integral part of top management, the CRO works across the functional structure of the company, managing risks as a portfolio and reporting directly to the board.

INDIAN PERSPECTIVE

The high-powered Naresh Chandra Committee, on Corporate Audit & Governance, which submitted its report in December 2002, seems to have been strongly influenced by the corporate scandals that hit the Western, especially the US markets last year. Some of the suggestions are evidently based on the much talked about Sarbanes - Oxley Act, passed by the US Government in 2002. Where the committee differs from its US counterpart is in firmly rejecting the need for a Public Oversight Accounting Board. This suggestion has run into severe problems even in the US. Even at home, it is felt that adding one more regulator may not be the correct step. It has recommended the setting up of Independent Quality Review Board to periodically examine and review the quality of audit, secretarial practice and cost accountancy and pass judgements and comments on the quality and sufficiency of systems, infrastructure and practices, for each of the three professional bodies namely the ICAI, the ICSI and the ICWAI.

As far as the committee's suggestion on having at least 50 percent independent directors on all listed companies boards, is concerned the flip side is that the suggestion has come at a time when professionals are shying away from accepting the post of independent director because of the civil as well as criminal liabilities that it might entail. The Department of Company Affairs (DCA) is already seized of the matter and is considering a proposal to dilute the responsibility of the board of directors. The rationale behind the move lies in the fact that directors are not involved in the day-to-day affairs of a company and therefore, should not be held responsible. Similar exemption is already available to government nominees on company's boards.

One of the major recommendations of the Naresh Chandra Committee on Corporate Audit and Governance is setting up of a Serious Fraud Investigation Office (SFIO) in the Department of Company Affairs (DCA). The Finance Minister in his budget speech, 2003-04, has mentioned that SFIO has already been setup in the DCA. The SFIO is conceived as a multi-disciplinary unit capable of investigating corporate white-collar crime professionally. The SFIO will only take up investigation of frauds characterised by (a) complexity and having inter departmental and multi disciplinary ramifications; (b) substantial involvement of public interest in terms of monetary misappropriation or in terms of number of persons affected; and (c) the possibility of investigations leading to, or contributing towards a clear improvement in systems, laws or procedures.

Also the final phase in the amended listing agreements of the SEBI requires that all listed companies induct independent directors in specified numbers and also introduce the attendant committees and compliances by March 31, 2003. Failure to do so would attract de-listing. Companies, which take these corporate governance requirements seriously, will confront, inter alia, three critical issues viz, (a) Locating competent directors who also need to have enough understanding of not only the legal duties but also the strategic ones (such as the industry analysis, strategic choices, risk assessment etc. that one of the training organizations has been leading in the country), (b) arriving at a compensation policy for the independent directors in such a way that it is not so good as to become largess nor too scanty that results in adverse selection and (c) handle the paradox of higher challenges in the less prosperous companies that actually need higher competence than the management for which the company has no money to pay.

Also, the Investment Information & Credit Rating Agency (ICRA) governance rating service launched recently is a good effort of good governance into quantifiable results. With governance ratings based on fairness, transparency, accountability, responsibility, emphasis on disclosure, and business practices the ICRA ratings seek to provide solid objective measures of these characteristics.

THE GLOBAL SCENARIO

UK and Germany pioneered the move towards enterprise governance by mandating auditor-certified corporate risk management reports. While the United States has also been a pioneer in this area, it focuses more on financial reporting, disclosure and independence of directors. Other European countries are stressing on the removal of immunities for board members, such as permanent tenure and confidentiality.

India has studied these pioneers closely and Indian regulation focuses on the need for greater disclosure and power for shareholders.

In the UK, Germany and the United States, there has been a time lag between the passing of corporate governance regulations and reorganisation of corporate risk management systems. This was primarily due to the lack of ready models. The regulations have, nonetheless, triggered a collective introspection of how new systems might be organised. The same pattern is likely to be followed in India over the next six to twelve months.

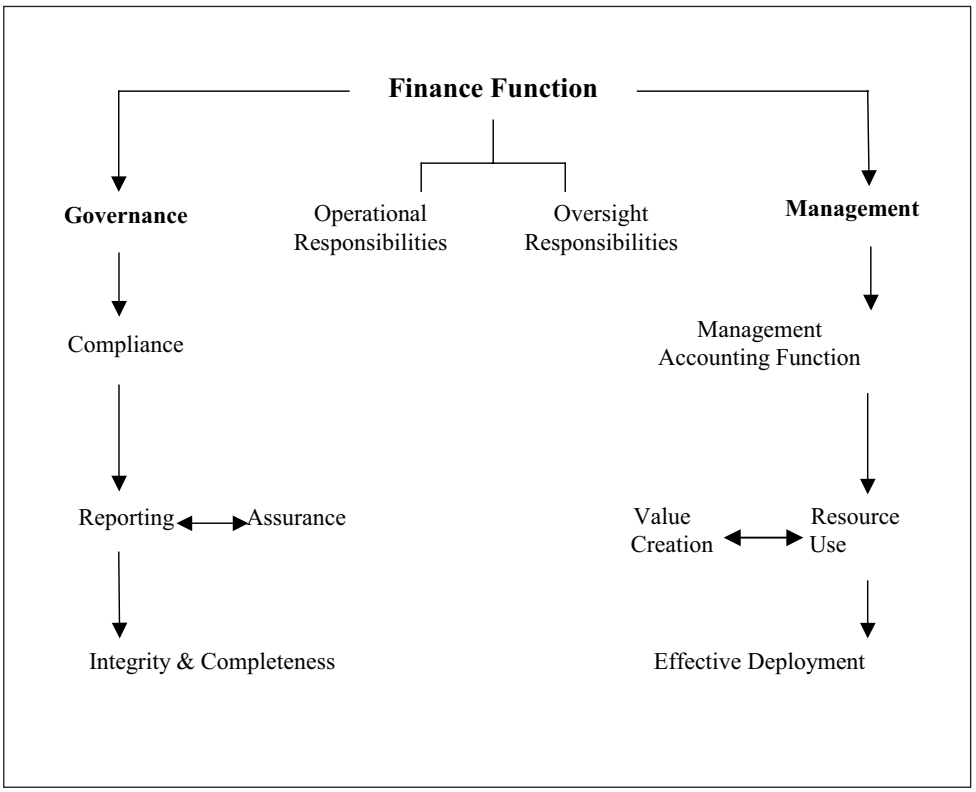
The new risk manager can take on many tasks. Integration can translate to organizational structures so that some of these tasks are part of the risk manager's portfolio, or integration may mean that these managers meet periodically with the risk manager to resolve common issues. The most effective risk managers integrate themselves with managers involved in:

- Crisis management
- Executive protection and corporate security
- Health and safety programs in the workplace
- Environmental auditing and monitoring systems
- Internal auditing
- Treasury cash management

An important new function that has been recently added to the risk manager's role is that of company spokesperson on matters of public concern over risk. Risk communication is an offshoot of risk management. The principles of effective risk communication need to be integrated with the rest of the senior management team, so that "one clear voice" is heard when significant events which affect the public occur. This new task is in line with the increased interest by organizations in reputation risk.

ROLE OF A CHARTERED ACCOUNTANT

A Chartered Accountant can play an important role in the risk management of an enterprise. The FMAC of IFAC has issued IMAP's I and specifies that the Finance function of any enterprise is inextricably linked with both governance and business management. He can render his services in ensuring compliance with the reporting and assurance requirements. He can also use his specialised knowledge to secure the effective deployment of funds and help in resource utilisation and value creation in an organisation. The services could include in particular fraud prevention, detection, investigation and developing reporting procedures to integrate risk management into everyday business practices.



CONCLUSION

A good governance framework pays big dividends. Beyond corporate governance, organizations also need to take a look at their enterprise governance and IT governance activities. Firms need to make sure they have a comprehensive and coordinated accountability framework that streamlines and focuses the tremendous resources of their firms to provide maximum and sustainable value.

In conclusion, an effective enterprise-wide risk management process can provide executive management and the board of directors with a framework to strengthen the governance process. Risk management can identify where exposures exceed the risk- tolerance limits and determine where investments in enhanced controls can most effectively mitigate remaining risks. The evolution of risk management can provide metrics for management and the board of directors to assess the relative returns from various forms of risk exposures and can help shape strategic decisions. For companies undergoing rapid growth and those engaged in relatively new business processes and practices, risk management can provide a method for developing an internal control infrastructure to support the success of the business strategy.

Further, the risk management framework can improve the transparency of disclosures to help investors and customers better understand the operations of the firm. I particularly want to emphasize that disclosure need not be in a standard accounting framework or exactly the same for all organizations. Rather, each entity should disclose the information its stakeholders need to best evaluate the entity's risk profile. Companies should be less concerned about the vehicle of disclosure and more concerned about the substance of the information made available to the public.

No business can afford to remain static, and firms of all sizes should continually pursue better ways to manage risk. The discipline of risk management is still relatively young. Investments in better forms of risk management processes often reduce losses and provide a more robust framework for evaluating business alternatives. Following sound risk management, governance, and disclosure practices consistently is also crucial to maintaining the confidence of capital and financial markets. Boards of Directors and executive management are responsible for ensuring that both Corporate Governance process and Performance Management process are conducted with competence and integrity. If a vibrant system of Enterprise Governance is adopted, our economic system should grow stronger. ■

ANNOUNCEMENT

All Members of the Council

We are pleased to inform you that the President, pursuant to the decision taken by the Council at its 232nd Meeting held in March, 2003 at New Delhi and in terms of the authority given to him by the Council at its 231st Meeting held in February, 2003, has constiuted a Committee for Review of Education & Training. The members of the said Committee for the year 2003-2004 are as follows:

1. Shri R. Bupathy, President (Chairman)
2. Shri Sunil Goyal, Vice-President (Vice-Chairman)
3. Shri R.S. Adukia
4. Shri Pankaj Inderchand Jain
5. Shri T.N. Manoharan
6. Shri Abhijit Bandyopadhyay
7. Shri Manoj Fadnis
8. Shri Amarjit Chopra
9. Shri Vinod Jain
10. Shri R.C. Chandiwala
11. Shri K.B. Sharma

The President has further decided that Shri C.R.T. Varma, Director of Studies, would act as the Secretary to the aforesaid Committee.

Yours faithfully
Sd/-
(Dr. Ashok Haldia)
Secretary