CORPORATE SUCCESS THROUGH EXCEPTIONAL GOVERNANCE

RISK MANAGEMENT STRATEGY FOR SUSTAINABLE GROWTH

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Background

Today's dynamic and rapidly changing business environment presents a number of risks for every company and the board. The risks can include, e.g., economic crisis, corporate frauds, crash of financial markets and systems, technology innovation and obsolescence, emerging markets, globalization, geopolitical, complex legal and regulatory systems etc. And then there are these "black swans", that is, completely unpredictable or unforeseen events, typically one time with extreme consequences, e.g., the Japanese earthquake, that have further complicated the market dynamics. Similarly, recent instances of major corporate frauds, whether in India or elsewhere, and the global financial crisis that we all had seen earlier, had severe adverse impact on the reputation as well as major erosion of shareholder value of many large corporations. Such disruptive events and subsequent negative impact on shareholder value have clearly established the fact that risk oversight and governance is becoming more and more imperative for today's Boards.

The Regulatory Mandate

Whereas boards of listed or joint stock companies across industries and around the world have already developed and implemented risk governance and oversight framework in some form or the other, boards of many private and other non-listed companies are still in the process of developing or are yet to formulate an approach for risk oversight and governance framework across their companies.

For the listed or joint stock companies, such risk oversight approach are primarily driven by respective regulators. Regulators in many countries are now proactively focussing on board risk oversight and accordingly are driving the policies and regulations surrounding it. For instance, the US Securities and Exchange Commission (SEC) requires that proxy disclosures address and focus on Board's role in oversight of company's risk management and governance process; the director's possess necessary qualifications and experience to understand company's risks; and the Board's compensation committee's evaluation of the company's various compensation arrangements to ensure that no excessive or unacceptable risks are either encouraged or undertaken. Similar laws, acts and guidelines have been formed in many countries, e.g., in India, the new Companies Act of 2013 mandates e.g., that *"the board of directors shall lay statement before company in general meeting indicating development and implementation of a risk management policy for the company including identification of elements of risk, if any, which in the opinion of board may threaten the existence of the company" (section 134).*

Similar policies and guidelines have been mandated by regulators in various countries e.g., Chairman of the Securities and Commodities Authority of the United Arab Emirates (SCA), the Capital Markets Authority (CMA) in Saudi Arabia and so on.

The Key Questions

With the ever challenging business environment and complex regulatory environment, the key questions for today's boards are:

- Has the board formulated and communicated the risk oversight objectives;
- If yes, do such objectives form part of Board's charter and agenda;
- How the board evaluates the effectiveness, achievement and continuous monitoring of defined risk oversight objectives and addresses any gaps identified in the process.

The Approach for formulating an effective risk oversight

In order to develop a comprehensive risk oversight framework and to further strengthen the existing risk governance processes, there are few key factors for consideration for the board and directors of the entity:

First, it is important for the directors to understand company's mission, vision, strategy, goals, objectives and key drivers of success. Given the dynamic environment in which the entity operates, the directors must understand and be aware of the key factors that will drive and at the same time, may affect value creation.

Given the dynamic nature of the business environment, there are various risks and challenges encountered by that entities. These may be external, i.e., determined or driven by external forces, e.g. commodity prices, regulations, cyber risks etc. or internal, for instance, risks related to business operations. Therefore, it must be ensured that towards pursuit of value creation and achievement of desired goals and objectives - potential uncertainties, risks and challenges that the entity may face, are comprehensively and thoroughly assessed. For that, a robust framework like COSO may be adopted. The COSO's Enterprise Risk Management (ERM) framework asserts that the boards and directors must ensure that the entity's strategy and business objectives align with the stated mission, vision, and core values and all critical

risks that threaten the execution of entity's strategy and business model, are identified and addressed as per determined risk appetite.

Next, to ensure that the entity has a robust risk management and governance structure in place, the roles and responsibilities of the board, including the standing committees and directors, with regard to governance of risk oversight, must be established and implemented. The board should assume the primary responsibility of risk oversight with the board's standing committees supporting the risks inherent in respective risk oversight areas.

Such roles and responsibilities, including those for risk identification, evaluation and monitoring should be clearly communicated to all stakeholders.

As mentioned earlier, it is important for the entities to comprehensively assess their risk spectrum, including all critical risks. It is important to note here that whereas risks are generally perceived negative or having an adverse impact, there are good risks that may be also be considered, e.g., potential investment opportunities, product diversification etc. Risk may include, but not limited to, are emerging risks (e.g. climate change, environmental degradation, increasing national sentiments and polarisation of societies, income disparity etc.), strategic risks, financial, compliance & operational risks etc. The boards must therefore, adopt a forward looking approach, specifically for emerging risks and ensure that the entity builds and develops sufficient resiliency to deal with any disruptive changes.

Once the critical risks are identified, the same must be assessed for the entity, i.e., in terms of a) probability or likelihood of that risk or event taking place, for instance if a risk is most likely to happen (e.g., foreign currency fluctuations, financial frauds, commodity price changes etc.) or least likely to happen (e.g., floods in desert) and b) the estimated potential impact should that risk event take place, e.g., major financial impact resulting in reduction in margins or profitability, environmental, health & safety impact etc. Accordingly, the strategy or control measures to mitigate or reduce the potential risk exposures must be determined.

Boards must therefore, ensure that such mitigation or controls measures are adequate, are continuously and effectively monitored and that the entity has adequate and sufficient resources to achieve this objective. An entity's risk management systems, including resources such as people, processes and technology should be sufficient and appropriate. These may include dedicated risk and compliance teams, e.g., CRO office, systems and defined policies and procedures, methodology, reporting and communication protocols etc.

With the establishment of communication and reporting protocols as part of the risk oversight and governance process, it is important to consider "what" must be communicated to the board and directors that is relevant for the risk oversight process. Often, there is too much information or agenda items that is shared with the board which overwhelms the board, dilutes the relevance of information and focus on insightful decision making is lost. A collaborative approach, therefore, must be adopted to work with board and management to identify only the matters that need board attention, e.g., critical and emerging risks, reporting formats, templates and dashboards as applicable and to be included in agenda item.

To ensure overall success of the risk oversight process, it is also important to ensure an effective communication protocol that encourages dynamic and constructive risk dialogue between the management and the board on risk matters, is established. When the key value drivers are identified towards achievement of an entity's goals and objectives, a number of assumptions are made or considered, e.g., market trends, global price movements, tariffs, duties etc. Such assumptions and variables may impact an entity either positively or negatively. Therefore, the risk oversight process must ensure that the board assesses and challenges such assumptions and variables from time to time with constructive dialogue. For instance, if the entity is suddenly making lot of profits, the factors that have resulted in such numbers, must be assessed and challenged to ensure ethical business practices have been followed by the management.

Another key factor to consider as part of risk oversight process is how the entity's culture and incentives structure drives the behaviour, decisions and attitude towards risk management. An entity, that is traditionally risk averse, may miss out on "good risk" opportunities (e.g., potential profitable investments), similarly, an entity that is characterized by highly risk aggressive profile or culture, may expose its resources adversely. The key is a balanced approach that guides the risk reward trade-offs, that the board needs to take into consideration. Many countries toady have developed and implemented employee reward and recognition programs for identifying and reporting of near miss incidents as a strategy to further improve and strengthen the risk culture at respective entities.

Often at times, it is observed that an entity is unable to create the desired value or for that matter, there is value depletion that is taking place resulting in non-achievement of desired goals and objectives. There can be many reasons for that. One of the key factor that is often attributed to this is misalignment between an entity's strategy and execution. This could be due to lack of or inadequate planning, governance process, oversight or communication challenges. For instance, if people who have been hired or assigned responsibilities for development of a new technical complex product do not possess the requisite skills or experience to execute the project, it is most likely to cause strategy misalignment. Though it is often hard for board and management to always ensure successful alignment of entity's strategy and execution, better planning and risk oversight process with continuous monitoring can help control the potential exposures.

Conclusion

An organization that aspires to create value for its shareholders should aim to have a robust risk oversight process with active participation of its board and directors. Warren Buffet had once mentioned "Never test the depth of the river with both the feet". The risks inherent in the entity's strategy and business plans, must be understood, identified, assessed, managed and controlled effectively with a defined and established risk oversight framework including governance and compliance structures. A greater emphasis on resilience, recovery, flexibility, diversity and risk-reward understanding can help organizations achieve sustainable growth over a longer period of time.

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