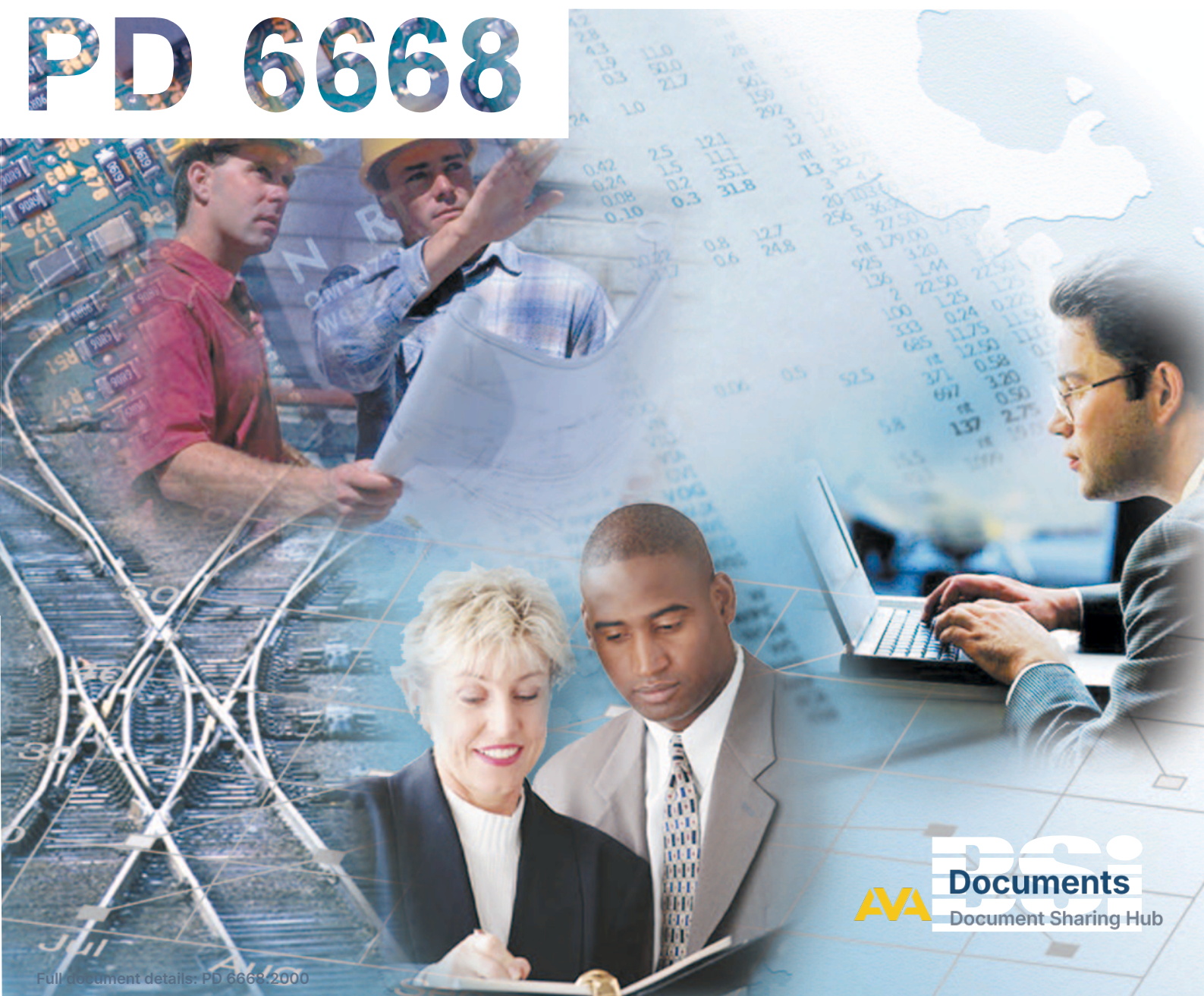




Managing Risk for Corporate Governance

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PD 6668



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Foreword

This document is a guide to how organizations can establish and manage their strategic risks. Organizations need to take risks in order to be successful and survive. Risks also exist that if realized can put an organization in jeopardy. These risks should be mitigated in some manner.

This document examines the pressure on organizations to be responsible in managing their strategic risks. This applies to organizations worldwide, in the private and the public sectors. It outlines a management framework for identifying the threats, determining the risks, implementing and maintaining control measures and finally reporting annually on the organization's commitment to this process.

The proper governance of companies will become as crucial to the world economy as the proper governance of countries. [1]

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0 **Introduction**

0.1 **General**

Corporate governance is the way in which corporations and other organizations are directed and controlled. The subject has attracted new interest in recent years. Despite some spectacular failures, [2] this is principally due to the greater social responsibility felt by the large institutions in the pensions and insurance fields. These organizations exercise a predominant interest in shareholders' meetings through their massive investments.

The problems arising from the separation of ownership and control of organizations have long been recognized. Legislation in the form of The Companies Act (under review) and similar has been the main means of regulation, along with stock exchange requirements. It is expected that these requirements will increase, particularly from investors.

A new element, which has been recognized only recently, is the role of risk management in corporate governance. It is with this aspect that this Published Document is principally concerned. It is not intended that organizations become risk averse. The aim is that they recognize that they should effectively manage all strategic risks. Unless an organization takes some risks it may fail in the marketplace.

It is recognized that there is a need for greater corporate accountability than exists currently. This document demonstrates the need for corporate governance and includes a systems approach to adopting effective arrangements, in the style of a management system standard.

The remainder of section 0 provides a background to the drivers for risk assessment in corporate governance. Sections 0.2 to 0.7 of this document give an outline of the broader considerations of corporate governance. The role of risk assessment and management is described in 0.8.

A more detailed description of an appropriate risk management system is given in section 3. This section lays out a framework of the issues that should be addressed and follows a Plan, Do, Check, Act (PDCA) approach that is consistent with international management systems standards.

Sections 4, 5 and 6 contain a practical guide to delivering business requirements with respect to strategic risk management.

Section 7 provides a questionnaire to enable benchmarking of organizations' existing arrangements.

0.2 **Background influences**

There are various definitions of corporate governance, such as "the system by which [large] companies are controlled and directed" [3]. A number of major institutions generally agree with this definition. The Organization for Economic Cooperation and Development (OECD) has the same definition and goes further to clarify it:

The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance. [4]

One of the main drivers for development in the field of corporate governance was the economic crisis in Asia which began in the late 1990s. Major investors realized that if they were to invest with minimum risk, rules should be in place to outline the principles of corporate governance. Typical of these investors is the Californian Public Employees Retirement System (CalPERS) which had over US\$155 billion in assets at the end of 1999. This organization has been prominent in promoting principles of corporate governance worldwide.

As a result of this crisis and following the Asia-Pacific Economic Cooperation (APEC) finance ministers' meeting in May 1998, measures were put forward which aimed to provide corporate governance structures in the Asian region. These activities are being funded by the World Bank and the Asian Development Bank.

It was noted that, "wherever there had been a corporate disaster, bad corporate governance had invariably been a key factor" [5] and consequently:

Corporate governance frameworks must ensure that management is held accountable for a corporation's performance and that owners are able to monitor and intervene in the operations of management. [5]

It was also acknowledged that different practices would apply to different countries and cultures and that no rigid rules could be enforced. The guidelines drawn up were seen as a base from which other rules and guidelines would be developed, varying from country to country. However, the general principles of the framework would be enforced, to ensure that there was some consistency from country to country. This would enable a common framework while ensuring that practices could be flexible enough to evolve. This is an essential part of corporate governance. It has to be rigid enough to be enforced in a consistent way all over the world in hugely different cultures and economies, while being flexible enough to change in the ever-evolving world of business.

A study by CalPERS resulted in six global principles, which they felt did not impinge upon the legal, economic and cultural traditions of any country. These are:

- a) director accountability to shareowners;
- b) transparent markets;
- c) equitable treatment for all shareowners;
- d) easy and efficient proxy voting methods;
- e) codes of best practice defining the director-shareholder relationship;
- f) long term corporate vision which at its core emphasizes sustained shareowner value. [6]

Organization A

Failure to carry out a strategic risk assessment

Organization A operates in the niche market of producing precision components for equipment that is no longer manufactured. The equipment is of high value and has a long life expectancy so Organization A can charge premium rates.

It enters into agreements with original equipment manufacturers (OEMs) and provides support with the transfer of manufactured components, dies, drawings, etc. from the OEM to Organization A. The organization operates on a large site and employs skilled workers, in a secure environment to reduce vandalism, burglary, etc. There is also a fire alarm system in place but no sprinkler system because of the fear of damaging plans, documents and valuable equipment.

A localized fire breaks out at night in the storage area through a fault in an electrical heater and destroys all the tooling, stored components and plans.

Although the organization is insured it has not identified any continuity arrangements in the event of such an emergency.

The organization can no longer manufacture components or provide back-up as it has no separate records, dies, etc. The OEMs are also threatening to sue for breach of contract and loss of their tooling and designs.

Organization A failed to carry out a strategic risk assessment which would have identified its vulnerability.

Four of the main organizations behind the move towards corporate governance are the International Corporate Governance Network (ICGN), OECD, the Commonwealth Business Council and CalPERS. Also, organizations such as the World Bank, the International Monetary Fund and national stock exchanges are important players in the move towards increased corporate governance.

The OECD has five major principles of corporate governance. These have generally been adopted by other organizations, which have added their own interpretations to the general principles. These principles cover the rights and equitable treatment of shareholders, the role of stakeholders, disclosure and transparency and the responsibilities of the board. These will be dealt with in **0.4.2** and **0.4.3**.

The fact that these major world organizations are involved shows the growing realization of the importance of corporate governance in an increasingly global market. Although these are still only principles, it will not be long before they are enshrined in company law, in some form. The Secretary of State for Trade and Industry has established a Company Law Review group, "which will produce its final report in March [2001]. This has begun a significant and important debate". He also mentions the "soon to be concluded regulation on the OECD multinational guidelines [which continue] the aim of setting standards for business". [3]

This demonstrates the importance of the issue, with regard to both internal and external investment, as well as its implications for company law. Corporate governance will become increasingly important in the global economy and integral to the operations of every company, large and small, public and private.

0.3 The UK Turnbull guidance for UK listed companies

In the UK a number of major, if not spectacular, failures by companies and public bodies have been attributable to poor corporate governance. There has been public outcry over the lack of accountability of directors and boards of companies after catastrophic events. This is particularly true of accidents involving major loss of human life or environmental pollution.

The UK Government is set to revise company law in 2001 or 2002. The Institute of Chartered Accountants for England and Wales (ICAEW) produced a guidance document, [7] under the chairmanship of Sir Nigel Turnbull (see annex A). It helps organizations meet the internal control requirements identified in the Combined Code for those companies listed on the UK London Stock Exchange. The guidance identifies, among other things, three key steps to delivering effective corporate governance, as shown in Figure 1.

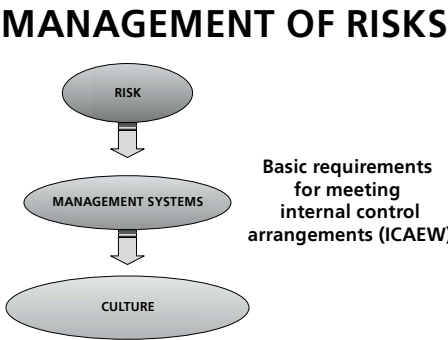


Figure 1 — Three key steps to delivering effective corporate governance

0.4 Importance of corporate governance

0.4.1 **General**

Corporate governance affects the whole of the world economy down to the individual worker or pension holder. There are many interested parties.

0.4.2 **Shareholders**

Corporate governance is important to shareholders for many different reasons, not least because it clearly defines the relationship between them and the company. This enables each party to be aware of their rights and responsibilities towards each other, in the interests of risk management and long term growth.

The OECD principles are that:

The corporate governance framework should:

- a) *protect shareholders' rights;*
- b) *ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights;*
- c) *recognize the rights of stakeholders as established by law and encourage active cooperation between corporations and stakeholders in creating wealth, jobs and the sustainability of financially sound enterprises;*
- d) *ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company;*
- e) *ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.* [8]

The first principle in the OECD guidelines relates to the rights of shareholders. In addition the Cadbury Report states that when problems arise, "It is for the shareholders to call the directors to book if they appear to be failing in their stewardship and they should use this power." [9] This has two implications for shareholders.

- a) It establishes that shareholders' rights need to be defined and protected.
- b) It means that shareholders play an integral part in corporate governance, by keeping a check on the actions of the company.

The second OECD principle is that all shareholders, including minority and foreign shareholders, should be treated in an equitable way. It goes on to say that shareholders should also "have the opportunity to obtain effective redress for violation of their rights". [8]

The ICGN backs up these principles by stating that:

*Major strategic modifications to the core business(es) of a corporation should not be made without prior shareholder approval of the proposed modification
...Shareholders should be given sufficient information about any such proposal..*
[10]

In summary, the importance of corporate governance to shareholders is that it stresses both:

- their rights as shareholders; and
- their role in keeping a check on corporate actions and decisions.

Corporate governance spreads the risk of making major decisions over a wider decision making area. Therefore, no one person is responsible for the future movements of a company in which many have an interest. This minimizes the risk. It also gives shareholders the right to question and perhaps seek redress if they feel that their views are not dealt with satisfactorily. Effectively, it gives a lot more power to shareholders with regard to the running of the company. It should be recognized though that their action will be retrospective, taken when they have the knowledge to judge the actions of top management.

0.4.3 Stakeholders

The importance of corporate governance to stakeholders is largely the same as for shareholders. In the OECD principles there is a small section dedicated to the "Role of stakeholders in corporate governance". [4] However, the importance of sustainability in corporate governance is discussed to a greater extent. The importance of stakeholders and corporations to wealth and jobs is also stressed.

The various principles identified by OECD and ICGN aim to define the relationship between corporations and stakeholders. This enables each party to know where the other stands with regards to the running and decision making of the organization.

0.4.4 Corporations

The relevance of corporate governance to corporations is that they are far more accountable for their actions than was previously the case. The ICGN states that:

The overriding objective of the corporation should be to optimize over time the return to its shareholders. Where other considerations affect this objective, they should be clearly stated and disclosed. To achieve this objective, the corporation should endeavour to ensure the long term viability of its business, and to manage effectively its relationships with its stakeholders. [10]

Corporations are now far more accountable to both shareholders and stakeholders, and this has an impact on how decisions are made and executed. There should be far more consultation and communication between the various groups before a corporation reaches a decision. Improved communication is essential. This may mean some corporations completely altering their decision making process in order to bring more people into it without compromising efficiency and flexibility.

0.4.5 Directors

Due to corporate governance, directors of organizations are accountable to far more people than was previously the case. The responsibility for an organization that fails to deliver or suffers as a result of poor management lies with its directors. It is they who have to face the consequences.

The OECD has laid out the responsibilities of the board, with regard to their functions, responsibilities and duties. The Department of Trade and Industry in conjunction with Deloitte and Touche has also followed this up in the UK in the Company Law Review. In November 2000, during the proposal stage, it suggested that:

...directors' duties should for the first time be included in the Companies Act... the basic goal for directors to be the success of the company in the collective best interests of shareholders, recognizing that this can only be achieved by taking due account of wider interests such as employees, customers, suppliers and the community, and the impact of business decisions on the company's reputation and on the environment...directors to take proper account of the long term consequences of their decisions. [11]

If these proposals are acted on in the UK, which is likely, they will have major consequences for directors and the way in which they operate. These proposals will hold them far more accountable for their actions and if they are found to be negligent then they could be prosecuted.

There is also a call for more frequent and open elections of directors. This is especially the case from groups such as CalPERS, which wield a huge influence in corporate democracy worldwide. This again makes directors more aware of their position and its responsibilities. The defining of the role of directors is perhaps one of corporate governance's most important ideas.

The ICGN suggests that boards should also set up independent committees consisting of non-executive members of the board. This would help to prevent any conflict of interest.

0.4.6 Private owner companies

The needs of smaller, private owner companies are also covered in the Company Law Review. One of its aims is to tailor the rules to such companies. Such tailoring includes:

- simplification of the capital maintenance rules;
- relaxation of the restrictions on the powers of the directors to issue shares;
- encouragement of greater use of arbitration in shareholder disputes; and
- a new model constitution specifically designed for private companies. [11]

This suggests that corporate governance is very relevant to smaller companies. Although some relaxation is necessary, rules will probably be implemented to which companies should adhere.

Organization B

Failure in risk assessment and supply chain management

Organization B is a high street retailer of designer cuddly toys for adults. Some production is in the UK, but the company also relies heavily on imports of its branded products made in Far Eastern developing countries. It exercises a strict quality control regime by inspecting suppliers' facilities as well as finished products. The goods attract high prices associated with quality branded products, but the market is fickle.

Organization B is suddenly rocked by allegations that its suppliers use slave labour and children under the age of 14, paying them a pittance. The media are slating Organization B for exploitation of workers and exorbitant prices.

By coincidence, just as the discovery emerges, Organization B announces that it is shipping most of its production overseas and cutting UK manufacturing work by 50%.

Two weeks later, workers for UK supplier companies and sympathizers are outside many Organization B outlets with placards and leaflets.

Organization B knew its market was fickle and vulnerable to hype. Adverse publicity about sources of materials, exploitation of people, etc. was known to be a risk. It failed in its risk assessment and also in the effective implementation of necessary controls.

A successful organization would have ensured that its buying department kept careful control of suppliers, in a manner that was consistent with its ethical business policy.

0.4.7 Public bodies

There is a need for corporate governance of public bodies in order to ensure proper codes of conduct. However, the framework has to be modified in order for it to be applicable.

In Australia it is recognized that:

Whereas corporations focus mainly on shareholder returns and the preservation of shareholders' value, the public sector's role is to cost-effectively implement programmes in accordance with Government legislation and policies. [12]

However, despite the difference between the public and private sectors, the basic principles are the same. It is essential that people know what they are responsible for and that they are therefore accountable. Within public bodies this probably varies more than within private ones.

There is also a drive for the public sector to be "more creative and prepared to take more calculated business risks in order to deliver the best possible services to the public". [13] The public and private sectors differ in this respect. The public sector needs corporate governance to enable it to take certain calculated risks, which at present it does not. The private sector needs corporate governance in order to minimize the risks that are taken in everyday business. Figure 2 is a diagram from BS 6079-3:2000 that shows one way of expressing the relationship between threat and opportunity when managing projects.

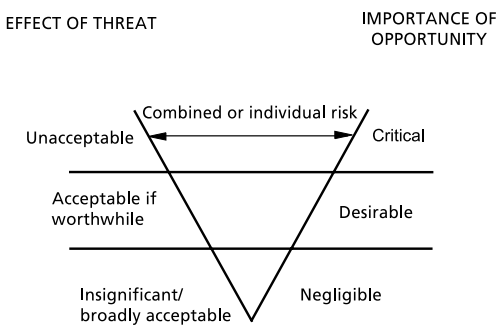


Figure 2 — Relationship between threat and opportunity

The Chartered Institute of Public Finance and Accountancy (CIPFA) has put forward the following statement in a consultation document to local authorities:

Corporate governance is the system by which local authorities direct and control their functions and relate to their communities [through] continuous improvement (including value for money and best value) and outward looking, accountable and responsive service. [14]

This leads to the conclusion that "risk management and internal control" should be included in the "different dimensions of a local authority's business".

The consultation document states that the arrangements that need to be made in order to include these controls should:

- include making public statements to stakeholders on the authority's risk management strategy, process and framework to demonstrate accountability;
- include mechanisms for monitoring and reviewing effectiveness against agreed standards and targets and the operation of controls in practice;
- demonstrate integrity by being based on robust systems for identifying, profiling, controlling and monitoring all significant strategic and operational risks;
- display openness by involving all those associated with planning and delivering services, including partners.

0.5 How does corporate governance apply to organizations?

Corporate governance in the UK is in its infancy in most organizations. However, it is becoming increasingly important. It is becoming more likely that it will become obligatory for companies to abide by the rules. Also, companies that want to be more attractive to outside investment should adhere to certain principles. This is especially true for inward investment from Pacific Rim countries where corporate governance is more advanced.

The application of corporate governance involves creating a more accountable board and more active shareholder participation. The growing involvement of the government shows how important the issue is. It is becoming increasingly applicable to all organizations. In his seminar on corporate governance, the Secretary of State for Trade and Industry declared, "Corporate governance is one of the key issues in the [company law] review. I believe corporate governance is likely to be a key issue in the next Parliament, because it is central to building a Britain of enterprise and opportunity". [3] The sooner companies begin to work towards good corporate governance, the easier it will be to adjust when it is incorporated in some form into company law. It is going to apply to all companies, both large and small, public and private. It may change slightly in form over time, but the basic principles are in place.

0.6 What are the barriers to good corporate governance?

There are many barriers to good corporate governance, whether intentional or not. One of the most significant barriers is that corporate governance is not actually part of company law. Although there are lots of principles, it is down to individual companies which, if any, of the principles they intend to follow. This will change, as the Secretary of State for Trade and Industry has indicated, probably in the next Parliament.

These barriers vary from country to country, as issues such as cultural differences affect implementation of corporate governance. This is not helped by the sometimes contradictory principles that various bodies develop. To be effective, there should be a coordinated standard that can be applied to companies from hugely varying backgrounds. Issues such as this will be addressed over time as countries begin to realize the importance of good corporate governance, as is happening in Asia.

0.7 How can organizations meet the requirements?

Meeting requirements depends upon the organization and the country in which it operates. One of the best ways to meet requirements is to work towards implementing the OECD principles, which seem to be the most generally accepted.