Risk Management's Role in Corporate Governance

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(code: article 13 FCGI/FAA/INA)

ABSTRACT: This paper reviews the relationship between the corporate governance and enterprise risk management, and considers the implications for the Indonesian enterprises. A brief concept of 'enterprise risk management', and the changing role of corporations are examined, with an increasing importance being placed on the role of Independent Boards to bring about an appropriate 'risk management' across the organization.

Introduction

Due to highly competitive nature and globalization of the business and industry nowadays, implementing the most professional level of corporate governance is now essential for Indonesian enterprises.

Enterprises will face severe deterioration in shareholders' confidence that may lead to higher capital costs and lower stock prices, unless improvements in their corporate governance are given top priority. This even more crucial for SOEs (State Owned Enterprises) who plan for privatization process in near future and need the confidence and trust from independent market players and reputation agents such as investment bankers, credit rating agencies, and investment managers.

Corporate Governance is a set of rules that define the relationship between shareholders, managers, creditors, government employees and other internal and external interested parties[2]. This set of rules then applies to their rights and responsibilities or the system by which the company is directed and controlled, as well as to create added value to the stakeholders. There are four essential principles of corporate governance: *Transparency, Independence* or *Fairness, Accountability* and *Responsibility*, which should be deployed in all and any aspect of corporate management.

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[2] Definition as suggested by FCGI (extracted from OECD)

To address the urgency of the adoption of better practices of good corporate governance, many countries including Indonesia have developed their own code of good corporate governance. Most of them are based on the suggested global references such as World Bank and OECD plus their specific country's industry and regulatory framework. In those codes, a specific concern is made on the risk management that should be addressed as one of the mandatory Board of Directors' and Commissioners' accountability & responsibility.

> **Malaysian Code**
>
> ***6 Principal responsibilities of the Board:***
>
> ***.. .. ..(3) Identifying principal risks and ensure the implementation of appropriate systems to manage these risks***
>
> ***.. .. .. (6) Reviewing the adequacy and the integrity of the company's internal control systems and management information systems, including systems for compliance with applicable laws, regulations, rules, directives and guideline***

In Malaysian Code, risk management is one (the 3rd) of the 6 principal responsibilities of the Board as quoted on the left-hand side picture. That responsibility is linked to the other responsibility (the 6th) on the company's internal control systems and management information systems.

In Indonesian Code of Good Corporate Governance that was issued in May 2000 by NCCG (National Committee of Corporate Governance), and in the Minister Decree of SoEs no: 117/2002 (part 3, p.28), the company is expected to disclose material foreseeable risk factors, including management assessment of the business climate and risk factors, as quoted on the right-hand side picture

> **Principle no: 7 of Indonesian Code**
>
> **Part 3, p. 28 Kep.Men BUMN no: 117/2002**
>
> ***Disclosure :***
>
> ***… … … In addition to Annual Report, company shall take initiative to disclose beyond required by prevailing law and regulations but also those of material importance, such as but not limited to: … … … Material foreseeable risk factors, including management assessment of the business climate and risk factors.***

> **Principle no: 2 of Indonesian Code**
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> **Ch. 4, Part 6, p. 14 (8) Kep.Men BUMN no: 117/2002**
>
> ***BoC's sub-committee Assurance & Risk***
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> ***… … …The sub-committee of Assurance & Business Risks shall do periodic assessment and provide recommendation of the business risks, the type and amount of the insurance for the concern BUMN to cover such business risks.***

It is subsequently tied to other principles and paragraph of Indonesian Code (2nd principle) and Minister Decree no: 117/2002 regarding Sub-Committee of the Board of Commissioners (BoC) part 6, p.14 (8)), that says a particular sub-committee of BoC – Assurance & Business Risks sub-committee – shall do periodic assessment and provide recommendation of the business risk management, as quoted on the left-hand side picture

In essence, the Boards should understand the principal risks of all aspects of the business that the company is engaged in and recognizing that business decisions require the

incurrence of risk. The target is to achieve a proper balance between risks incurred and potential returns to shareholders. This requires boards to ensure that there are systems in place that effectively monitor and manage these risks with a view to the long-term viability of the company.

Meanwhile, the prolonged economic crisis since 1997 has raised the risk of doing business in Indonesia. Economy program is standstill and getting far off the ground whereas prevailing new laws and regulations especially the 'regional autonomy', new consumer and labor laws may cause new extra costs for company operations. In the banking and financial sectors, IBRA (Indonesian Bank Restructuring Agency) is still struggling since they are far behind the target milestones. Together with arising horizontal social conflicts and community development issues especially in Aceh provinces, Sumatera and Kalimantan, they are all coloring Indonesia country risk profile to the worst than ever. Beyond such domestic issues, enterprises in Indonesia are also facing the truly globalization dynamic change effects: 1) Revolution in telecommunication and internet that brings economy into digital era – hence a borderless economy; 2) The implementation of WTO and AFTA those will certainly bring about a new rule of the game for Indonesian Enterprises.

At a sudden, they are forced to redefine and restructure toward the new paradigm of market and competition. They are also facing a new challenge of managing business and risks that becomes characterized by knowledge-based underlying competitive forces and advantages. As a result, the importance and substance of company strategic assets are turning from the size of company's hard and concrete assets such as machines, plants, and buildings to become the company's knowledge-based assets such as competency, skill, database, innovation, networking, and effective value driven integrated business process.

How to protect the company knowledge-based asset are far more complex than protecting the hard assets such as buildings and plants? In some instances, company might not even know what they have or have not in this regard. They often fail to see both the asset and the associated potential business risks as it cannot be simply measured. Instead, it requires a serious and coordinated effort from management to do what so called *"enterprise risk management',* sometimes just called as 'Risk Management'.

What is Risk?

"Risk is the chance of something happening that will have an impact upon objectives[3]." Risk is "a condition in which there is a possibility of an adverse deviation from a desired outcome that is expected or hoped for[4]." Risk equals to uncertainty, the higher the uncertainty is, the risk of doing business is greater.

[3] Definition as suggested by Australian Risk Management Standard 4360
[4] Definition as suggested by Vaughan, Vaughan

Company risk is grouped into two categories: Financial Risk and Non Financial Risk. Financial Risk consists of four sub-risks:

- Market Risk, the risk of financial loss resulting from a change in the value of tradable assets.
- Credit Risk, the risk of financial loss resulting from a default of the counterpart.
- Operational Risk, the risk of financial loss resulting from operational failure.
- Reputation Risk, the risk of financial loss resulting from the loss of business attributable to a decrease in the institution's reputation.

Non-Financial Risk is viewed from two perspectives:

- Micro perspective; the risk resulting from uncertainty due to the internal elements of institution such as: people, process, event, and system and technology.
- Macro perspective; the risk resulting from uncertainty due to external factors such as: Government, Industry and domestic business environment, Society, and international business environment.

Other scholars and many risk management experts simply define risk as the result of its consequences and its likelihood. Consequence is the size of risk, of five levels of impact: 1) catastrophic, 2) major, 3) moderate, 4) minor, and 5) insignificant. Whereas likelihood is probability of risk occurring, five possibilities of happening: 1) certain, 2) likely, 3) moderate, 4) unlikely, and 5) rare.

Enterprise Risk Management

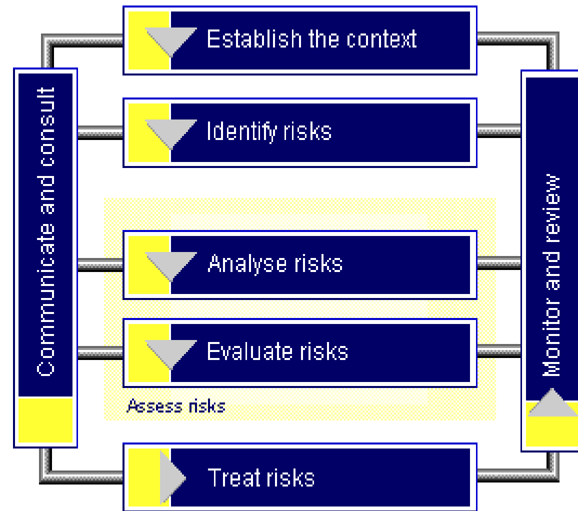
Risk Management has enjoyed a significantly enhanced profile and usage in recent years, being used in many areas from internal auditing to project management. Risk Management had its origins in the insurance industry dating from the mid-1950s, when insurance buyers attempting to gain increased recognition and status, began to expand their function to include loss prevention, industrial safety and employee benefits[5].

Insurance is an integral part of the risk management process, however <u>it is only one possible risk treatment involving risk sharing or risk transfer, in the whole risk analysis, assessment and management chain</u>. Insurance can provide protection against large and unexpected losses, however the real financial benefits come only from the reduction or control of the risks themselves.

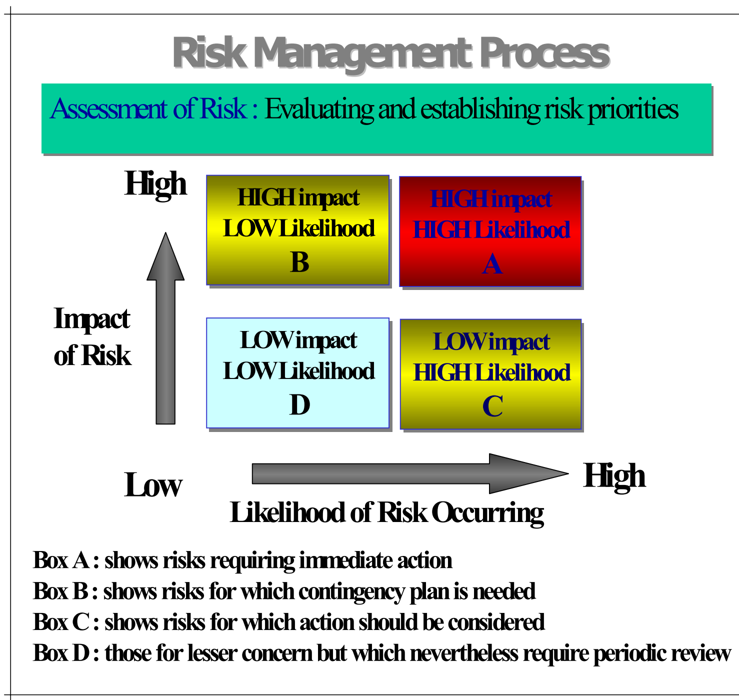
The most significant boost to the standing, understanding and potential use of risk management came with the publication of the Australian and New Zealand Standard of Risk Management (AS/NZS 4360: 1995) in 1995. <u>The standard specifies the elements of the risk management process, is generic and independent of any industry or risk management system</u> and has given a recognition and credibility to the concept and practice. The standard describes Risk Management as:

[5] K.W. Knight, *History of the Risk Management Discipline,* Brisbane - Australia, 1996.

...an interactive process consisting of well-defined steps which, taken in sequence, support better decision-making by contributing a greater insight into risk and their impacts. The Risk Management process can be applied to any situation where an undesired or unexpected outcome could be significant or where opportunities are identified ...



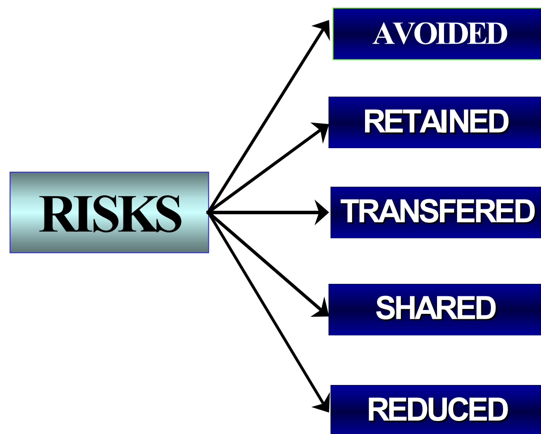
As illustrated in the right-hand side picture, Risk Management is the term applied to a logical and systematic method of identifying, analyzing, assessing, treating, monitoring and communicating risks associated with any activity, function or process in a way that will enable organization to minimize losses and maximize opportunities.



The standard further describes the main elements of the risk management process above (see the following two pictures on the left-hand side, and below):

- Establish the strategic, organizational and risk management context, the criteria against which risk will be assessed, and the structure of the analysis.
- Identify what, why, and how things can arise.
- Analyze risks determining the existing controls and analyzing risks in terms of likelihood and consequence in the context of those controls.

How to Manage or Treat the Risks?



- Assess and prioritize risks.
- Treat risks (note: five possible treatments: a) avoid the risk by not doing the business initiative, b) retain the risk and accept the consequence if it occurs, c) transfer the risk through insurance and or cooperation with others, d) share the risk through insurance and or cooperation with others, e) reduce the risk through risk mitigation actions and or embedded internal control mechanisms).
- Monitor and review the performance of the risk management system and changes which might affect it.

Risk Management, Internal Audit and Control

Internationally internal audit has more recently discovered risk management and risk-based auditing. Internal Audit has traditionally been most concerned about internal controls. Risk assessment in internal auditing is increasingly used to identify, measure and prioritize risks so that the focus is placed on auditable areas of greatest risks. Risk based auditing moves the focus from the past (historical operation of the internal control system) to the future, where they test the way management mitigate risks[6].

Mandatory establishment of Audit Committee as suggested respectively in Bapepam circulation letter no: BAPEPAM No. SE-03/PM Year 2000, and Jakarta Stock Exchange (JSX) Director's letter no: Kep. 339/BEJ/07-2001 dated on July 20, 2001 for Indonesian public listed companies, and Minister Decree no: 117/2002 for Indonesian SoEs, clearly states three principal domains of role and responsibility of the Audit Committee:

- Company's disclosure, especially those related to Company's financial disclosure
- Company's Internal Control Practices
- Company's Corporate Governance Practices

The Audit Committee is expected to help and or support the BoCs in those three domains, which principally deals with risk management aspect of the company. If certain enterprises have their own separate Risk or Assurance Committee, they will function as dedicated sub-committee of BoCs which focus solely to help and or support the BoCs on

[6] D. McNamee, "Risk Based Auditing", *Internal Auditor*, August 1997, p. 23

the company's risk management, especially on the company's risk policy, risk mitigation plan, and risk treatment. In that regards, the Risk Management Committee should work and complement each other with the Audit Committee to assure an effective full cycle of risk management process be in place.

The common and widely accepted and respected methodology for building effective internal control framework that contains embedded risk management aspect is *COSO*[7] *internal control framework*. According to COSO, Internal Control is a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories: 1) Effectiveness and efficiency of operations; 2) Reliability of financial reporting; 3) Compliance with applicable laws and regulations. It integrates the company's operation system, information system, and management system, and recognizes three level of control hierarchy or protection: 1) Control Environment as first level or overall protection; 2) Pervasive Control Plans as second level protection; and 3) Application Control Plans as third level protection.

One of the example of an effective control environment is the existence of corporate code of conducts that applied to all organization stakeholders inside and outside, from boards member to all blue collar employee, from suppliers to customers and community. It provides a clear and respected ethical behaviors' control and reference for people not to do a wrong doing against company and all stakeholders. Yes, it is about ethics. Ethics as the company's core values upon which all and any organizational policies and procedures should be based.

Boards' Independency and Competency in Risk Management

The quality of implementing Good Corporate Governance principles: *Transparency, Independence* or *Fairness, Accountability* and *Responsibility*, will be depending on how far the company boards will take those principles consistently in actions. When we deal with Risk Management, it demands two pre-requisites: Boards' independency and competency.

Boards' Independency is required to assure that company would be stimulated to keep fairness to all stakeholders especially for the minority shareholders, protecting them against fraud, self-dealing or other insiders' wrong doing. It will also enforce company transparency to all stakeholders through improved disclosure of accurate and timely information on corporate performance as well as risk factors. We could expect that Boards' Independency will be happening through the existence of Independent Commissioners and or Independent Directors as imposed by the Bapepam and JSX for Indonesian Public listed companies, and by Minister of SoEs for Indonesian SoEs.

Boards' competency is required to assure that company boards are well equipped with the right and effective Risk Management tools and methodologies, no chance and time for

[7] Committee of Sponsoring Organizations of the Treadway Commission

trial and error approaches. In this regard, the independent boards member especially the independent commissioners should be the Chairman of risk management committee. In smaller size company or boards, the chairman of Risk Management Committee could be the same person who is the chairman of Audit Committee. Whereas, in a larger size and more complex company or boards, the chairman of Risk Management Committee ideally is a different person to the chairman of Audit Committee. Either way, to be effective in this particular role of risk management, the incumbent should be an experienced professional who have a very strong industry background, sensitive to the impact of unfavorable macro-economy volatility and government regulations. If necessary, as enthusiasm alone is not sufficient, the incumbent must have been well exposed in risk management concept and practices either through a formal tertiary education or proven tracked record experiences.

Conclusion

The ultimate objective of Good Corporate Governance is company's value creation through sustainable company performance as a result of doing business in appropriate manner. Since the company performance and risk are, in fact, inextricably linked; the structures and processes associated with good corporate governance practices can improve organizational performance while simultaneously reducing liability risks. Boards and senior management commitment to align the structure and process of good corporate governance with organizational objectives will appropriately position the Indonesian enterprises in preparing themselves to embrace the hyper dynamic global competition drives whilst at the same time to overcome and deal with so many domestic unfavorable issues for business community.

As said by many management gurus, 'the most dangerous risk in corporate management is 'a comfort ignorance' believing that things will not go a miss'. Let's start now a proper risk management as things already gone wrong. There will not be any case that a company will reach 'good corporate governance' without a proper corporate enterprise risk management in place. Prepared for any business risks in appropriate manner, tell the truth to the stakeholders, and be fair in any corporate actions.

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