



# Challenges in implementing Enterprise Risk Management

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# Overview

The year 1912 witnessed one of the greatest tragedies claiming 1500 lives, which has become a case study in ineffective risk management. The RMS Titanic struck an iceberg on 14 April 1912 and sank on the morning of 15 April 1912 during her maiden voyage across the Atlantic Ocean to New York. The causes for the wreck have since been diagnosed and discussed at length, though, with the frustrating advantage of hindsight.

But the reasons behind the tragedy lie elsewhere. The foremost among those was the non-existent structure for detecting and handling risks. In fact, the impending risks were blatantly overlooked. Safety was compromised in the attempt to break the speed barrier; there were not enough life boats for the passengers, and weak communication lines collapsed in the wake of calamity. So, why did these risks get overlooked?

History has run many chapters since. The context has changed, the players are different, but the principles remain the same. In today's challenging global economy, business opportunities and risks are constantly changing. Dynamism is the key to succeed in business today. However, the difference between corporate successes and failures is often the ability (or inability) to manage the risks underlying an opportunity. Management of risks continues to be a challenge for modern managers as the companies looking at new opportunities must continually come up with better and efficient strategies to mitigate associated risks.

Risk management, as often pointed out, is a process. More importantly, it is an evolving process. The concept and its application have matured through a number of stages based on the requirements of the business environment. The evolution phase of Risk Management can be captured in three major stages, namely:

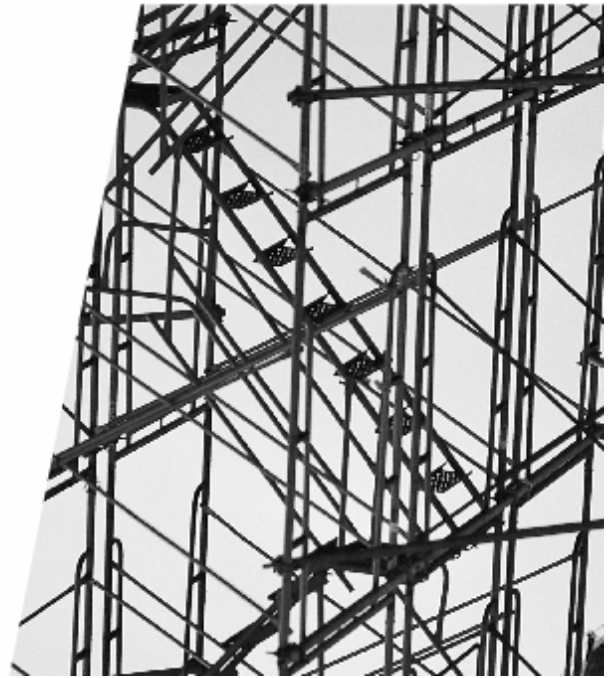
- ▶ **Functional Risk Management:** In the first stage the focus of risk management was on financial risks and related internal controls. Specifically, the scope of risk management was limited to areas such as Treasury, Insurance and Credit
- ▶ **Business Risk Management:** The second stage of risk management expanded the scope from financial risks to cover hitherto uncovered areas such as operations and strategy. It is at this stage that risk management started getting discussed and practiced actively by companies outside the 'Financial Services' domain. The focus at this stage was primarily on the organizational level risks
- ▶ **Enterprise Risk Management (ERM):** ERM is the last stage in the evolution process, where the focus has moved from the organization level to the key constituents (process, departments, geographies etc.) of the organization. Here, the risk management strategies are applied across the organization at every level. The objective of ERM is to create and preserve enterprise value by extending the focus of risk management to cover all of its key constituents

ERM is a broad concept as it is applied to all sources of value, not just physical or financial assets.

In response to the need for guidance in the design and implementation of ERM, a number of frameworks have been disseminated or are being developed. The most widely known of these frameworks, COSO's Enterprise Risk Management Integrated Framework was released in 2004. Committee of Sponsoring Organizations (COSO), a voluntary organization dedicated to improving the quality of business reporting, defines ERM as

*“A process effected by an entity's board of directors, management and other personnel, applied in strategy-setting and across the enterprise, designed to identify potential events that may affect the entity and manage the risks to be within its risk appetite, to provide reasonable assurance regarding achievement of entity objectives”*

ERM departs from the fragmented approach of other risk management solutions and tries to provide a holistic view of the whole enterprise. It is evident from the definition that ERM has to be initiated by the Board of Directors. Hence it is a top-down approach and involves the commitment of each and every employee. ERM helps the firm in finding a balance between its risk taking endeavors and risk mitigation efforts. It helps firms in formulating strategies based on the risk analysis of their operating environment.



In the Indian context, ERM assumes added significance due to the risks that come with an economy growing at a blistering pace. The entire ecosystem of Indian businesses is changing as the effects of globalization and liberalization become more pronounced. Moreover, the tools for growth are also evolving. Entrepreneurship has become a widespread business phenomenon. Inorganic transactions are increasingly becoming the chosen route for expansion and efficient resource utilization. However, each opportunity and the method chosen to realize it, comes at an inherent risk. To leverage these opportunities over the longer term, companies must internalize risk management as a part of their growth strategy.

Indian companies often approach these risks in a haphazard manner and fail to comprehensively assess and hence, build effective strategies to mitigate them. Very often, companies become aware of these risks only after they strike and disaster management, rather than risk management, surfaces as a forced reaction.

# Challenges

This paper attempts to identify some of the challenges that companies face when implementing the ERM framework. Rather than a rule book stating what not to do, the next section should be viewed as a description of mission critical factors that management should prepare before they undertake the risk management exercise.

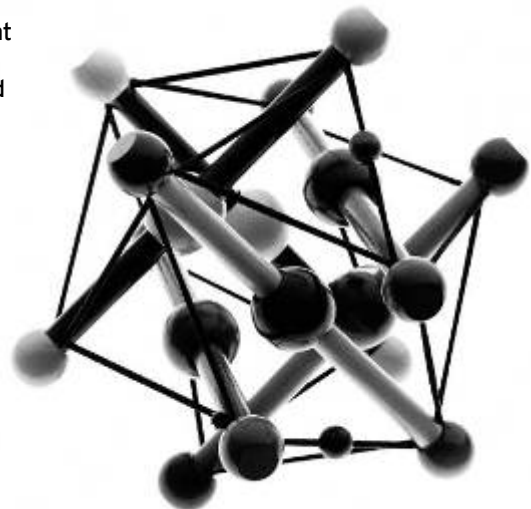
## 1. Support from top management

Discipline starts at the top with a committed CEO and executive management who support ERM through consistent actions that create and sustain momentum for the initiative. Once the need is established, top management must be able to create a compelling vision and communicate it effectively throughout the organization.

After establishing the vision and enunciating the risk management objectives, the management should drive the ERM exercise in a systematic manner to ensure satisfactory completion. In most organizations where ERM has been successfully implemented, management initiated the process by defining a clear project plan and setting up an ERM Project Team/Task Force to ensure involvement at all levels. Through such steps, the management shows its commitment to risk management and consciously creates an environment conducive to positive change.

Therefore, establishing ownership of ERM at the highest level of the organization is critical. Without the support of the CEO and the Board of Directors, ERM cannot be effectively implemented. Lack of support manifests itself in a number of ways:

- ▶ Absence of shared vision and a compelling business case: A business case addresses the internal and external pressure points that create the need for change as well as the state of readiness and existing structures which can drive or constrain change. The business case should be grounded in the organization's priority risks and in the gaps of capabilities managing those risks. It should assert why risk management is integral to strategy setting
- ▶ Lack of engagement by the CEO: ERM follows a top-down approach and therefore the CEO needs to clearly set the vision and the path to be followed
- ▶ Earnest but unsuccessful efforts by the lower management to sell ERM upwards: The absence of clear vision at the top leads to ambiguity in response and lack of ownership in the higher management, and sincere efforts by the lower management to internalize ERM are either not supported timely or ignored altogether.
- ▶ Lack of senior management presence in status meetings: Commitment from the top is crucial to the risk management effort, without which the project may veer off-course or never really take off

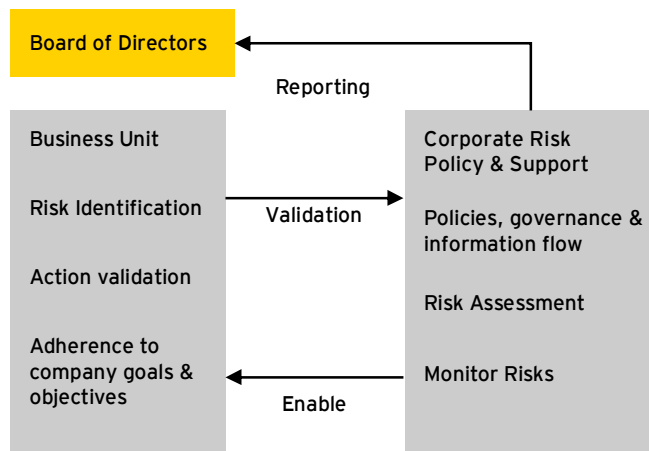


## 2. Linking ERM to the business goals and strategies

In an ideal scenario, risk management is viewed as an enabler to achieve an organization's strategic objectives and an integral part of the strategic planning process. Internalized risk management can act as an effective filter to refine the strategic thought process of the organization. Developing such an approach to risk management is essential for successful leveraging of business opportunities.

However, in case of most organizations, risk management is treated as an exercise isolated from the organization's strategic direction. Rather than being a preventive mechanism, the risk management output becomes a mere post-mortem report for business failures.

A related dimension to integrated risk management is the strategic establishment of a communication framework and reporting structure. The figure below shows an example of integrated information flow. The policies and organizational goals are formulated by the top management. This information is passed on to the business units and to the risk management department. Based on these goals, the corporate risk unit implements an ERM system and formulates risk policies. These policies are communicated to the Board and to the business units. The business unit ensures adherence to the organizational policies as well as risk policies. Any deviation from the set standards is immediately reported to the Board of Directors by the corporate risk unit.



**Integrated information flow**

In positioning itself as part of the ERM infrastructure, the Board should pay specific attention to the interplay between risk analysis and the strategic decision-making process. Long-term strategic choices are discussed at the Board level and agreed upon with leading executives, who are then entrusted with the implementation. This process is very delicate because the Board must ensure that no self-dealing or other conflicting interest prevail over the interest of the corporation and its shareholders. Thus the ERM business case should be formulated as a concise and effective mission statement, articulated in the main program objectives, and tied to the firm's strategic goals.

## 3. Sound analysis and comprehension of the industry

The industry scenario in which the business operates needs to be minutely analyzed for proper implementation of the framework. The mechanisms of every industry are different and also very dynamic. Since risk management, by its very nature, adopts a futuristic approach, insight into industry trends is vital to the organization's level of preparedness. Lack of in-depth understanding of the industry in which the organization operates may lead to an unsuitable design of the ERM framework.

The industry's inherent qualities (labour/capital intensive, cyclicity, supplier base) define the risk management concept and principles for efficient implementation. The nature of the industry decides the nature of risks the company is exposed to and the techniques it uses to mitigate them. For example, a company operating in the I.T. domain in India will be more exposed to foreign exchange risk, whereas a bank will be more exposed to interest rate and credit risk. Again, apart from the commonly cited nature of risks, the businesses are exposed to risks due to the government's policies and intervention. These risks are especially high in case the company is dealing in public utilities or basic commodities. We have seen the government intervention in pricing of sugar and cement over the past few years. These risks are very industry specific and require attention while implementing the framework. Further, even in the same industry, different companies will have an array of methods to successfully implement the framework though the basic model and components may be the same.

#### 4. Lack of comprehensive knowledge about the organization

In a risk-sensitive scenario, not only the decision makers but also the people associated with the daily operations of the business should contribute to building the 'big picture' of the organization's risks. Detailed knowledge about the organization and its functioning is vital to the implementation of 'best fit' Enterprise Risk Management. Inadequate knowledge of the strategic planning and operations of the organization may result in zero value addition from a sub-optimal ERM framework.

Implementation without emphasis on business issues and value drivers will not succeed. Connection between the business agenda and Enterprise Risk Management is vital in order to link the enterprise risk to the value drivers effectively by focusing on the priority risks using the business strategy. Lack of knowledge about the key business drivers would, undoubtedly, make risk assessment, which is the bedrock of any ERM framework, produce a sub-optimal output.

Enterprise Risk Management needs to be integrated with prior and firsthand knowledge about strategic management, business planning, performance management, quality management, capital expenditures, etc. It is important to understand the operational setting of the organization so that the risk management process is aligned with the current and future state of the organization. Another important aspect is not to get caught up in pleasing one and all by making them part of the risk assessment exercise but to include people who, either alone or collectively, have comprehensive knowledge about the organization.

#### 5. Focus on assessing current risk management capabilities

The excitement levels during an implementation are mostly high till the risk identification and prioritization phase. These eventually dip once the risk mitigation phase commences due to the possibility of additional responsibilities and clear accountabilities getting fixed. Invariably it has been noticed that when a company decides to implement ERM, identification and evaluation of the existing capabilities within the organization to mitigate the identified risks is ignored. Every mitigation plan is identified as a new and additional task, which may result in redoing an existing activity.

For each individual risk or group of related risks, management must evaluate the current state of the organization's risk management capabilities. At that point, management must decide how much added capacity is needed to achieve the entity's risk management objectives. The goal is to identify the entity's most pressing exposures and uncertainties and to focus improvement activities on the elements of ERM infrastructure needed to manage those exposures effectively. The company should try to integrate its current risk management capabilities with its new system. Thus ERM transforms risk management to a proactive, continuous, value-based, broadly focused and process driven activity.



## 6. Integration of fragmented expertise within the enterprise

People with requisite knowledge, expertise and experience execute a company's strategy through its various functions and processes. Since management of risks depends on the coordinated efforts of various competencies within the enterprise, risk management should be viewed as a coordinated effort of functions at all levels. The roles and responsibilities of participating process owners must define and delineate risk event owners and mitigation plan owners as well as the interaction and the information and decision flows between related functions. Overall responsibility of implementing improved risk management capabilities can rest with one or more process/function owners, but, the primary ownership of the risk should reside with only one function to facilitate better control, coordination and ease of reporting.

Clarifying roles and responsibilities is always a challenge in risk management and particularly so with ERM. This is because current risk management approaches are so firmly rooted in the command and control area, they often lead to silo behavior that spawns gaps (no owner of a risk) and overlaps (too many owners of a risk) over time.

People at various levels and belonging to varied units may be mission critical to the successful implementation of ERM. The critical task is to integrate these fragmented expertises together in order to arrive at a holistic risk management framework for the enterprise. Failure on the company's part will land it in a situation where ERM, in all likelihood, will not be capable of meeting its primary goal.

## 7. Creating awareness and employee orientation

Though ERM is a top-down approach, its implementation affects the whole enterprise. ERM will only be successful if each and every employee of the enterprise is accountable and responsible for his/her actions and if he/she takes part in the ERM project diligently. Teams should have a sense of responsibility towards organizational policies and the risk measures. But most companies fail in this respect as they are unable to create an enabling environment for the successful implementation of ERM.

Experience has shown that:

- ▶ Employees are not adequately educated about ERM and its implications: Most employees tend to be hostile to any changes in their work environment. This happens even when a new system is set up in an enterprise. Such a hostile view from employees can severely impact the implementation of ERM. It can be avoided only if employees are provided adequate training on ERM, how it affects the organization and their role in the implementation process
- ▶ Employees are not provided appropriate training: An important infrastructure of the risk management function is the quality of people. Quality of people can only be maintained if the employees are provided adequate training about the ERM process
- ▶ Employees are not made accountable for their actions: Companies fail to make employees accountable and responsible for their actions. This results in employees taking an individualistic view rather than an organizational view thus hampering the implementation process

Due to such flaws, employees lack trust in implementation of the system. This leads to distrust within the team and creates an unhealthy atmosphere for effective implementation of ERM. Proper training on ERM techniques is essential for integrating risk management and instituting the required cultural change across the organization. The topic of risk education should be fully discussed at the board level with inputs from the ERM Executive Committee, where present.





In fact, line executives participating in the committee tend to be the most informed about how receptive business unit managers may be and what it takes to ensure that the underlying vision of ERM is fully understood and shared by them. Because of the direct relationship with unit leaders, ERM Executive Committee members can decide on what coaching methods should be adopted (e.g., developing an ERM manual, holding risk-based workshops, establishing Intranet message boards, etc.)

## 8. Integrating risk management into core business processes

The organization's processes are its primary means of executing its business strategy and policies. Risk responses and control activities are desirably integrated within business processes because risks are best managed and controlled as close as possible to the source. The ERM framework needs to be implemented through the organization's internal value chain to ensure preservation of value at each stage.

Most 'risk-managed' organizations accomplish this integration by establishing a comprehensive risk management and reporting structure. This structure is formed through a network of identified risk owners and mitigation owners across the organization's core business processes. Furthermore, activity timelines and reporting frequencies are pre-defined to ensure efficient risk management systems.

Such a risk management framework which is embedded in the organizational fabric can go a long way in making it truly risk resilient.

## 9. Compliance focused activity

ERM started evolving when the corporate sector was in doldrums globally. Bankruptcy filings and accounting scandals became a common feature. This led to calls for more effective corporate governance and finally led to the Sarbanes Oxley Act. Now companies were under a strict watch and they had to ensure better legal compliance. Many companies adopted ERM systems to fulfill their compliance regulations. In many companies, ERM still remains a compliance-focused activity. This can be a big hindrance in the implementation process as the companies fail to recognize the actual benefits of ERM, for instance:

- ▶ ERM improves an entity's risk management capabilities in a constantly changing environment. Improved risk management capabilities result in reduced performance variation. It helps in improving the operating performance by managing Key Performance Indicator (KPI) shortfalls
- ▶ ERM helps in increasing the transparency of an entity's risks and its risk management capabilities. It helps in building the confidence of the investors and the stakeholders

A company which has implemented ERM can manage unexpected risks better vis-à-vis a company which has not implemented ERM. Thus the company can successfully respond to today's dynamic environment.

## Conclusion

To summarize, we can say that for overcoming key challenges in implementation of ERM, its application must be enterprise wide and an entity-level view must be taken for all risks concerning the business. If the framework does not take a holistic view of the business across all key business risks, it fails to cover the entire enterprise. In order to meet the essential requirements it should be closely linked to the assessment and formulation of the business strategy. Successful implementation of ERM will allow managers to use robust processes. Again the management contribution to ERM cannot be overemphasized. Ultimately it is the management which takes important decisions about how to respond to risk, establish control and the cost associated in establishing the entire framework. This does attract human errors and mistakes in the implementation because the management has the power to override the ERM decisions. These errors can, however, be minimized if the management addresses the following issues carefully:

- ▶ Understand and identify the organization's priority risks
- ▶ Assess the organization's current risk mitigation capabilities and decide the enhancements needed for strengthening its risk management capabilities
- ▶ Design the ERM framework and provide the necessary infrastructure for implementation and monitoring, including the possible use of technology
- ▶ Embed risk management into the core business processes rather than taking it up as a 'one-time' project

The ERM framework, once established, would act as a natural mechanism to benefit the organization and enable it in preventing or restricting to acceptable levels, the potential damage that may be caused by risks to which it is exposed. Thus to survive in today's rapidly changing business scenario, organizations which are flexible and adapt easily would be ahead in the race. The playing field is becoming increasingly level with reduced entry barriers and common competencies. In such a scenario, a well instituted ERM framework can become the source of competitive advantage for an organization. ERM works as an organization wide gearing mechanism, honing systems and skills to utilize opportunities while mitigating risks. Management should therefore no longer look upon ERM as an option, but as a necessity for growth.

Aditya Gupta  
Sidhant Gupta  
Pushkar Tendolkar

Ambarish Jajodia  
Sumana Lahiry  
Shrijit Somasekhar

# Symbiosis Centre for Management & Human Resource Development (SCMHRD)

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Symbiosis Centre for Management & Human Resource Development (SCMHRD)

Symbiosis Infotech Campus, Plot No.15,  
Rajiv Gandhi Infotech Park,  
Hinjewadi, MIDC, Pune- 411057  
Contact: 098908 69996  
099754 09996  
Email: [financeclub@scmhrd.edu](mailto:financeclub@scmhrd.edu)

For more information, please visit [www.scmhrd.edu](http://www.scmhrd.edu)

# Our offices

## **Ahmedabad**

Shivalik Ishan Building  
2nd Floor  
Beside Reliance Petrol Pump  
Ambavadi  
Ahmedabad - 380015  
Tel: +91 079 66083800  
Fax: +91 079 66083900

## **Bangalore**

"UB City", Canberra Block  
12th & 13th floor  
No.24, Vittal Mallya Road  
Bangalore - 560 001  
Tel: +91 80 4027 5000  
Fax: +91 80 2210 6000

## **Chennai**

TPL House, 2nd floor  
No 3, Cenotaph Road  
Teynampet  
Chennai - 600 018  
Tel: +91 44 2431 1440  
Fax: +91 44 2431 1450

## **Gurgaon**

Golf View Corporate Tower - B  
Near DLF Golf Course  
Sector 42  
Gurgaon - 122002  
Tel: +91 124 464 4000  
Fax: +91 124 464 4050

## **Hyderabad**

205, 2nd floor  
Ashoka Bhoopal Chambers  
Sardar Patel Road  
Secunderabad - 500 003  
Tel: +91 40 2789 8850  
Fax: +91 40 2789 8851

## **Kolkata**

22, Camac Street  
Block 'C', 3rd floor  
Kolkata - 700 016  
Tel: +91 33 6615 3400  
Fax: +91 33 2281 7750

## **Mumbai**

6th floor & 18th floor  
Express Towers  
Nariman Point  
Mumbai - 400 021  
Tel: +91 22 6657 9200 (6th floor)  
+91 22 6665 5000 (18th floor)  
Fax: +91 22 6630 1222

Jolly Makers Chambers II  
15th floor, Nariman Point  
Mumbai - 400 021  
Tel : +91 22 6749 8000  
Fax : +91 22 6749 8200

Jalan Mill Compound  
95, Ganpatrao Kadam Marg  
Lower Parel,  
Mumbai - 400 013  
Tel: +91 22 4035 6300  
Fax: +91 22 4035 6400

## **New Delhi**

6th floor, HT House  
18-20 Kasturba Gandhi Marg  
New Delhi - 110 001  
Tel: +91 11 4363 3000  
Fax: +91 11 4363 3200

## **Pune**

C-401, 4th floor  
Panchshil Tech Park  
Yerwada (Near Don Bosco School)  
Pune - 411 006  
Tel: +91 20 6601 6000  
Fax: +91 20 6601 5900

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