FREQUENTLY ASKED QUESTIONS

BUSINESS STRATEGY AND RISK MANAGEMENT

BUSINESS STRATEGY

What is a business strategy?

A business strategy is a depiction that articulates the plans of the entire business. It is a plan that is often used so that they can attract financing from big investors as well as creditors. This is a plan designed to give information regarding a new venture so that they can convince financial backers to invest in the said business. It describes the market opportunities that the business intends to develop, the process on how they are going to do it and the resources that are required to make it possible.

"**Business strategy** is less a function of grandiose predictions than it is a result of being able to respond rapidly to real changes as they occur. That's why strategy has to be dynamic and anticipatory." - **Jack Welch.**

A good business strategy is the base ingredient for a successful business. However, there are many different kinds of business strategies. The best business strategy should be able to guide your company into a direction wherein the expected internal pressure due to business continuity meets the great demand of the fast-changing world for the revolutionary business plans.

What are the broad types of strategy?

There are basically three types of strategies in which business holders must concern themselves:

1. **Strategy in general.** This refers to how a specific objective will be achieved. The strategy in general mainly concerns the relationship between the results we want to have and the resources that are currently at our disposal.

2. **Corporate strategy.** This defines the market and the business segment wherein a certain company will operate. Corporate strategy is usually decided through the context of being able to define the company's mission and vision. This is the same as being able to recognize what the company does, why it exists in the first place and what it intends to become in the future.

3. **Competitive strategy.** This describes competitive ability of a given business and a strategy around it. This type of strategy is centred on the company's capabilities, its strengths, and weaknesses. This is used in relation to the market characteristics as well as the corresponding abilities, strong points, and weaknesses of the competitors.

How do we create a business strategy?

An essential first step in business performance management is creating a business strategy which in turn sets the way forward and the parameters for business intelligence strategy or infrastructure. The creation of strategy usually involves several steps:

1. Set a Vision and a Mission Statement
2. Five forces Analysis
3. SWOT analysis - Strengths, Weaknesses, Opportunities and Threats
4. PEST Analysis
5. GE/McKinsey Matrix
6. ADL Matrix
7. Highlighting Core competencies
8. Setting Goals / Objectives

9. Setting Key Performance Indicators or KPIs

What are vision, mission and values statements?

Vision Statement

A vision statement is a strategic intent of an organization. It is an overarching set of aspirations which the MSME hopes to achieve or become. These are the inspiring words chosen by successful leaders to clearly and concisely convey the direction of the MSME organization.

The above vision statements reflect high level statements which inspire the insiders of the enterprises as well as the world at large.

Mission statement

A Mission Statement defines the organization's purpose and primary objectives. Its prime function is internal – to define the key measure or measures of the organization's success – and its prime audience is the leadership team and stockholders. A mission statement describes what the organization needs to do now to achieve the vision. The vision and mission statements must support each other, but the mission statement is more specific. It defines how the organization will be different from other organization in its industry.

To create a mission statement,

- We need to identify the organization's "winning idea".
- This is the idea or approach that will make the organization stand out from its competitors and is the reason that customers will come to us and not to our competitors.
- Next, we need to identify the key measures of the success of the organization.
- Combine the winning idea and success measures into a tangible and measurable goal.
- We need to refine the words until we have a concise and precise statement of our mission, which expresses our ideas, measures and desired results.

Values statement

The values statement is also called the code of ethics and differs from both the vision and mission statements. The vision and mission state where the organization is going (vision) and what it will do to get there (mission). The values statement defines what the organization believes in and how people in the organization are expected to behave—with each other, with customers and suppliers, and with other stakeholders. It provides a moral direction for the organization that guides decision making and establishes a standard for assessing actions. It also provides a standard for employees to judge violations. From my experience in DuPont, it has the following value statement:

- Safety
- Ethics and
- People treatment

Here it needs to be remembered that these core values are not just statements written in policy documents. The organization and its people need to live these core values and demonstrate the same in day to day working environment of the organization.

What is five forces analysis?

Michael Porter's Five Forces tool is a simple but powerful tool for understanding where power lies in a business situation. This is useful, because it helps the organization to understand both the strength of its current competitive position, and the potential strength of a position where it aspires moving into.

Five Forces Analysis assumes that there are five important forces that determine competitive power in a business situation. These are:

- **Supplier Power:** Here we evaluate how easy it is for suppliers to drive up prices. This is driven by the number of suppliers of each key input, the uniqueness of their product or service, their strength and control over our business, the cost of switching from one to another, and so on. The fewer the supplier choices we have, and the more we need suppliers' help, the more powerful our suppliers will be.

- **Buyer Power:** Here we ask ourselves how easy it is for buyers to drive prices down. Again, this is driven by the number of buyers, the importance of each individual buyer to the business, the cost to them of switching from the entity's products and services to those of someone else, and so on. If you deal with few, powerful buyers, then they are often able to dictate terms to you.
- **Competitive Rivalry:** What is important here is the number and capability of the competitors of the organization. If it has many competitors, and they offer equally attractive products and services, then it will in all likelihood have little power in the situation, because suppliers and buyers will go elsewhere if they don't get a good deal from the organization. On the other hand, if no one else can do what the organization does, then it can demonstrate a competitive advantage.
- **Threat of Substitution:** This is affected by the ability of the organization's customers to find a different way of doing what it does. For example, if it supplies a unique software product that automates an important process, people may substitute by doing the process manually or by outsourcing it. If substitution is easy and substitution is viable, then this weakens the power of the organization.
- **Threat of New Entry:** Power is also affected by the ability of people to enter the market reach of the organization. If it costs little in time or money to enter its market and compete effectively, if there are few economies of scale in place, or if there is little protection for the organization's key technologies, then new competitors can quickly enter its market and weaken its position. If on the other hand the organization has robust and durable entry barrier, then it can preserve a favourable position and take fair advantage of it.

What is meant by SWOT Analysis?

SWOT Analysis is an effective technique for understanding Strengths and Weaknesses of the organization, and for identifying both the Opportunities open to it and the Threats it faces.

Used in a business context, a SWOT Analysis helps the organization to carve a sustainable niche in the market it operates.

Use of Analytics to make this technique successful would make us answer the following questions related to a target organization:

Strengths:

- What advantages does the organization have?
- What does it do better than anyone else?
- What unique or lowest-cost resources can it draw upon that others can not?
- What do people in the market it operates perceive as its strengths?
- What factors mean that it "get the sale"?
- What is the organization's Unique Selling Proposition (USP)?

Weaknesses:

- What could the organization improve?
- What are the activities it should avoid?
- What are people in the market it operate likely to see as our weaknesses?
- What factors drive the organization to lose sales?
- How the organization can improve its internal systems and processes?

Opportunities:

- What are the opportunities that the organization can identify?
- What are the development trends it can lay its hands on?
- Are there changes in technology and markets which can be converted to Opportunities?
- Are there changes in government policy related to its field of operation which may drive reforms?

- Are there positive changes in lifestyle patterns, social changes, and demographic profiles?

Threats

- What are the obstacles the organization faces?
- Whether the activities of the competitors have been mapped?
- Are quality standards or specifications for its job, products, or services changing?
- Are the operations of the organization threatened by changing technology in its line of business?
- Does the organization anticipate bad debt or cash-flow problems?
- Could any of the perceived weaknesses of the organization seriously threaten its business?

As a result of the SWOT Analysis, the organization may decide to specialize in rapid response, good value services to local businesses and local government.

What is meant by PEST Analysis?

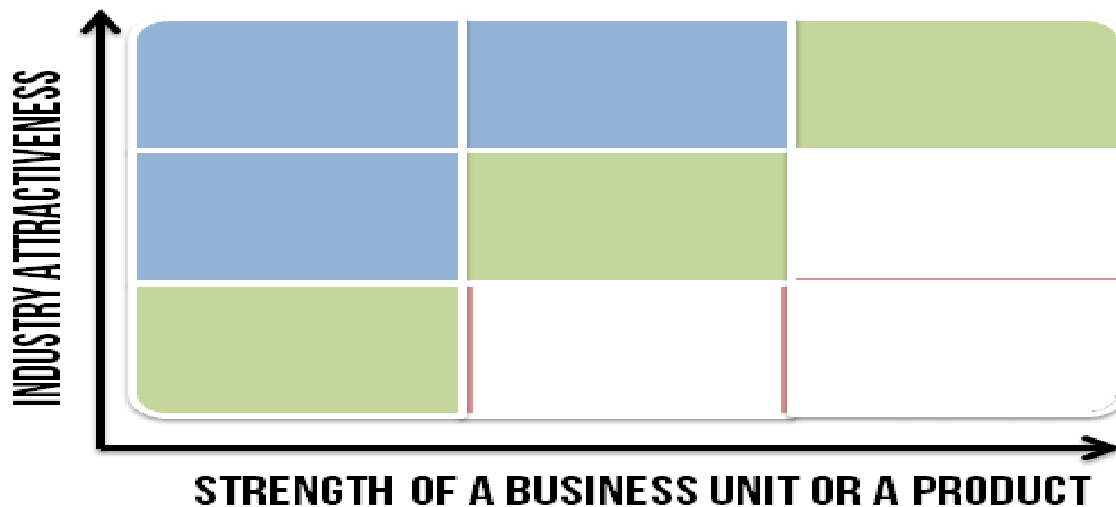
PEST Analysis is a simple but important and widely used tool that helps to understand the big picture of the **P**olitical, **E**conomic, **S**ocio-Cultural, and **T**echnological environment the organization is operating in. PEST is used by business leaders worldwide to build their vision of the future.

It is important for these reasons:

- By making effective use of PEST Analysis, the organization ensures that it is aligned positively with the forces of change that are affecting our world. By taking positive steps to usher in the change, it has more likelihood to be successful.
- Positive use of PEST Analysis helps the organization to avoid taking action that is destined towards failure for reasons beyond its control.
- PEST is useful when the organization starts operating in a new country or region. Use of PEST Analysis assists the organization to break free of theoretical assumptions, and helps the organization to quickly adapt to the realities of the new environment.

What is GE / McKinsey matrix?

This is a tool which is applied to solve the problem where to invest in a multi business environment by comparing the business units and assigning them to the groups that are worth investing in or the groups that should be harvested or divested.



The nine-box matrix shown above designed by McKinsey & Co, plots the Business Units on its 9 cells that indicate whether the company should invest in a product, harvest/divest it or do further research on the product and invest in it if there are still some resources left. The BUs are evaluated on two axes: industry attractiveness and a competitive strength of a unit.

Industry Attractiveness

Industry attractiveness indicates how hard or easy it will be for a company to compete in the market and earn profits. The more profitable the industry is the more attractive it becomes. When evaluating the industry attractiveness, analysts should look how an industry will change in the long run rather than in the near future, because the investments needed for the product usually require long lasting commitment.

Industry attractiveness consists of many factors that collectively determine the competition level in it. There is no definite list of which factors should be included to determine industry attractiveness, but the following are the most common:

- Long run growth rate
- Industry size
- Industry profitability: entry barriers, exit barriers, supplier power, buyer power, threat of substitutes and available complements (Use Porter's Five Forces analysis to determine this)
- Industry structure (use Structure-Conduct-Performance framework to determine this)
- Product life cycle changes
- Changes in demand
- Trend of prices
- Macro environment factors (use PEST Analysis for this)
- Seasonality
- Availability of labour
- Market segmentation

Competitive strength of a business unit or a product

Along the X axis, the matrix measures how strong, in terms of competition, a particular business unit is against its rivals. In other words, managers try to determine whether a business unit has a sustainable competitive advantage or not. If the company has a sustainable competitive advantage, the next question is: "For how long it will be sustained?"

The following factors determine the competitive strength of a business unit:

- Total market share
- Market share growth compared to rivals
- Brand strength (use brand value for this)
- Profitability of the company
- Customer loyalty
- Strength of a value chain
- Level of product differentiation
- Production flexibility

What is meant by ADL Matrix?

This is a Portfolio Management technique and is based on the Product Life Cycle. It has been developed in the 1980's by Arthur D. Little, Inc. (ADL), one of the best-known consulting firms, intended to help companies to manage their basket of product businesses as a portfolio.

Like other portfolio planning matrices, the **ADL matrix** represents a company's various businesses in a two-dimensional matrix. It is a structured methodology for consideration of strategies which are dependent on the life cycle of the industry. The ADL approach uses the dimensions of environment assessment and business – strength assessment i.e. Competitive Position and Industry Maturity.

The Competitive Position

A Company's competitive position is determined by strategic actions and competitor's strategies. Quality and strength of competitive position are indicators of company's strength. The ADL matrix categorizes every segment of company according to its position which can be dominant, strong, favorable, tenable, or weak.

Dominant: This is a comparatively rare and typically short-lived. In many cases is either to a monopoly or a strong and protected technology leadership.

Strong: Market share is strong and stable, regardless of competitors. The firm has a considerable degree of freedom over its choice of strategies and is often able to act without its market position being unduly threatened by its competitors.

Favourable**:** Business line enjoys competitive advantages in certain segments of market. However, there are many rivals, and no clear leader among stronger rivals. Results in the market leaders a reasonable degree of freedom.

Tenable: Position in overall market is small or niche, either geographical or defined by product. Competitors are getting stronger.

Weak: Continuous loss of market share. Business line is too small to maintain profitability.

Industry Maturity

Industry maturity could almost be renamed into "Industry life cycle". Of course, not only industries should be considered here but also segments. There are four categories of industry maturity: embryonic, growth, mature and aging.

Embryonic: The introduction stage, characterized by rapid market growth, very little competition, new technology, high investment, and high prices.

Growth: The market continues to strengthen, sales increase, few (if any) competitors exist, and company reaps rewards for bringing a new product to market.

Mature: The market is stable, there is a well-established customer base, market share is stable, there are lots of competitors, and energy is put toward differentiating from competitors.

Aging: Demand decreases, companies start abandoning the market, the fight for market share among remaining competitors gets too expensive, and companies begin leaving or consolidating until the market is demise.

Positioning into one of the four categories is a very sophisticated procedure and depends on many factors.

Steps in creating ADL Matrix:

- Determine the SBU's of the company (strategic segmentation done by clearly defined procedures)
- Identify phases of industrial maturity for each SBU (this should be done for each business in all SBU's)
- Determine SBU's competitive position (company's competitiveness in specific, narrow defined industry)
- Plot sizes and positions of SBU's on ADL Matrix.

A specimen matrix would look as under:

How do we define core competencies?

In their key 1990 paper "The core competence of the Corporation" C.K.Prahalad and Gary Hamel argue that "Core Competences" are some of the most important sources of uniqueness: These are the things that a company can do uniquely well, and that no-one else can copy quickly enough to affect competition.

Prahalad and Hamel used examples of slow-growing and now-forgotten mega corporations that failed to recognize and capitalize on their strengths. They compared them with star performers of the 1980s (such as NEC, Canon, and Honda), which had a very clear idea of what they were good at, and which grew very fast.

Because these companies were focused on their core competences, and continually worked to build and reinforce them, their products were more advanced than those of their competitors, and customers were prepared to pay more for them. And as they switched effort away from areas where they were weak, and further focused on areas of strength, their products built up more and more of a market lead.

Hamel and Prahalad provided three tests to see whether these are true core competences:

Tests	Narrative
Relevance	Firstly, the competence must give your customer something that strongly influences him or her to choose your product or service. If it does not, then it has no effect on your competitive position and is not a core competence.
Difficulty of imitation	Secondly, the core competence should be difficult to imitate. This allows you to provide products that are better than those of your competition. And because you are continually working to improve these skills, means that you can sustain its competitive position.
Breadth of application	Thirdly, it should be something that opens up a good number of potential markets. If it only opens up a few small, niche markets, then success in these markets will not be enough to sustain significant growth.

What are Key Performance Indicators (KPI)?

Key Performance Indicators are quantifiable measurements, agreed to beforehand, that reflect the critical success factors of an organization. They will differ depending on the organization. Some examples are provided below.

- A business may have as one of its Key Performance Indicators the percentage of its income that comes from return customers.
- A school may focus its Key Performance Indicators on graduation rates of its students.
- A Customer Service Department may have as one of its Key Performance Indicators, in line with overall company KPIs, percentage of customer calls answered in the first minute.
- A Key Performance Indicator for a social service organization might be number of clients supported and assisted during the year.

Whatever Key Performance Indicators are selected, they must reflect the organization’s goals, they must be key to its success, and they must be quantifiable (measurable). Key Performance Indicators usually are long-term considerations. The definition of what they are and how they are measured do not change often. The goals for a particular Key Performance Indicator may change as the organization’s goals change, or as it gets closer to achieving a goal.

What are the attributes to be considered while setting goals?

While setting Goals the following attributes should be covered:

Specific: Goal objectives should address the five Ws… who, what, when, where, and why. Make sure the goal specifies what needs to be done with a timeframe for completion. Use action verbs… create, design, develop, implement, produce, etc. Example: resolve accounting discrepancies within 48 hours.

Measurable: Goal objectives should include numeric or descriptive measures that define quantity, quality, cost, etc. How will you and your staff member know when the goal has been successfully met? Focus on elements such as observable actions, quantity, quality, cycle time, efficiency, and/or flexibility to measure outcomes, not activities. Example: secure pledges from ten new donors by the end of each week.

Achievable: Goal objectives should be within the staff member's control and influence; a goal may be a "stretch" but still feasible. Is the goal achievable with the available resources? Is the goal achievable within the timeframe originally outlined? Consider authority or control, influence, resources, and work environment support to meet the goal. Example: obtain the XYZ professional certification within two years.

Relevant: Goals should be instrumental to the mission of the department (and ultimately, the institution). Why is the goal important? How will the goal help the department achieve its objectives? Develop goals that relate to the staff member's key accountabilities or link with departmental goals that align with the institutional agenda. Example: develop and implement a diversity recruitment plan that increases the number of diversity candidates by ten percent.

Time-bound: Goal objectives should identify a definite target date for completion and/or frequencies for specific action steps that are important for achieving the goal. How often should the staff member work on this assignment? By when should this goal be accomplished? Incorporate specific dates, calendar milestones, or timeframes that are relative to the achievement of another result (i.e., dependencies and linkages to other projects). Example: check the fire alarms and emergency lighting in all buildings every six months.

How do we define a Business Plan?

A business plan is a:

- Live document that we refer to regularly and which can be changed and updated
- Toolkit to help guide our actions and steer our way towards our goals
- Great way to showcase the organization, passion, and creativity
- Opportunity to work out the finances and demonstrate financial sustainability
- Way of showing how the organization would achieve its social impact
- Statement of where the organization is now and where it wants to be.

RISK MANAGEMENT

What is risk?

According to Dowd (2005), risk refers to the chance of financial losses due to random changes in underlying risk factors.

A risk is a random event that may possibly occur and, if it did occur, would have a negative impact on the goals of the organization. It is the probability of incurring loss due to unexpected and unfavourable movement of certain parameters.

Risk is composed of three elements — the scenario, its probability of occurrence, and the size of its impact if it did occur (either a fixed value or a distribution). Risk is thus measured by volatility.

What is political risk?

Political risk is defined as "the possibility of a multinational company being significantly affected by political events in a host country or a change in the political relationships between a host country and one or more other countries". Political risk is the unwanted consequences of political activities that will have effect on the value of the firm.

What is meant by country risk?

The country risk is defined as exposure to a loss in offshore lending, caused by events in a particular country, events which are, at least to some extent, under control of the Government but definitely not under the control

of a private enterprise or individual. Country risk is a broad concept encompassing sovereign, political as well as other forms of risks like economic, social and external risks.

What is meant by economic risk?

Economic risk is concerned with the general economic climate within the country. Some of the factors which reflect the economic climate of a country are:

(a) level of affluence enjoyed by the country.

(b) the growth rate of income.

(c) the nation's propensity to save/invest.

(d) the stability of prices (inflation).

(e) characteristics of the labour force.

(f) level of sophistication of the financial system.

(g) level of foreign debt outstanding.

(h) major income earners (exports) and their sensitivity to overall global economic changes.

(i) extent of dependence on major export items.

(j) trend in balance of payments.

(k) level of imports

(l) level of reserve and credit standing, and

(m) fluctuation of exchange rate and controls on foreign exchange.

What is meant by social risk?

Social risk refers to the possibilities of loss due to factors such as religious fanaticism, ethnic polarization, dissatisfaction among the people as a result of wide disparity in income distribution, or regionalism. These sociological problems eventually lead to riot and revolutions resulting in loss of lives and property. An economy plagued by riots and revolutions will undoubtedly face problems in repaying its debts.

How do we define external risk?

The external risk component of country risk arises due to situations outside the country. For instance, if the borrower nation is situated beside a country which is at war, the country risk ratios of the prospective borrower will be higher than what will be the case if its neighbour is at peace. This difference in the risk rating is attributable to external risk.

What is meant by Exchange risk?

The liability of the borrower of the foreign currency financing remains in the currency in which the borrower obtains loan, hence at the time of repayment the rupee liability is determined on the basis of the exchange rate prevailing on the date of repayment. The exchange rate fluctuates widely with the passage of time, so the borrower is subject to exposure to exchange rate fluctuations on the outstanding principal of the foreign currency financing. Further if the borrowing is made at a floating rate of interest, there can be substantial variations in the rate of interest with the passage of time, depends on the variations in the LIBOR.

What is meant by Business risk?

A company's business risk is determined by how it invest its funds i.e., the type of projects which it undertakes, while financial risk is determined by how it finances these investments. A company's competitive position, the industries in which it operates, the company's market share, the rate of growth of the market and the stage of maturity all influence business risk. Business risk relates to volatility of revenues and profits of a particular

company due to its market conditions, product mix, input availability, competitive market condition, labour supply etc

How do we define financial risk?

Financial risk is primarily influenced by the level of financial gearing, interest cover, operating leverage, and cash flow adequacy. The financial risk depends on the method of financing adopted by the company. Financial risk is associated with the capital structure of a firm. A firm with no debt financing has no financial risk.

What is meant by convertibility risk?

It is that portion of the total variability of return from a convertible bond or a convertible preferred stock that reflects the possibility that the investment may be converted into the issuer's common stock at a time or under terms harmful to the investor's best interests.

How we define currency risk?

These are associated with international investments not denominated in the home currency of the portfolio manager's beneficiaries. These risks involve the international payment of cash.

What is meant by systematic risk?

Systematic risk refers to that part of total risk which causes the movement in individual stock price due to changes in general stock market index. Systematic risk arises out of external and uncontrollable factors. The price of individual security reflects the fluctuations and changes of general market. Systematic risk refers to that portion of variation in return caused by factors that affect the price of all securities

What is meant by unsystematic risk?

Unsystematic risk is that portion of total risk which results from known and controllable factors. Unsystematic risk refers to that portion of the risk which is caused due to factors unique or related to a firm or industry. The unsystematic risk is the change in the price of stocks due to the factors which are particular to the stock. For example, if excise duty or customs duty on viscose fibre increases, the price of stocks of synthetic yarn industry declines. The unsystematic risk can be eliminated or reduced by diversification of portfolio

What is meant by market risk?

The market risk arises due to changes in demand and supply, expectations of the investors, information flow, investor's risk perception etc. Variations in price sparked off due to real social, political and economic events are referred to as market risk.

How do we define interest rate risk?

The return on investment depends on the market rate of interest, which changes from time to time. The cost of corporate debt depends on the interest rates prevailing, maturity periods, creditworthiness of the borrowers, monetary and credit policy of the central bank, riskiness of the investments, expectations of the investors etc. The uncertainty of future market values and the size of future incomes caused by fluctuations in the general level of interest are known as 'interest rate risk'.

What is meant by Purchasing Power risk?

Uncertainty of purchasing power is referred to as risk due to inflation. If investment is considered as consumption sacrificed, then a person, purchasing securities, foregoes the opportunity to buy some goods or services for so long as he continues to hold the securities. In case, the prices of goods and services, increases during this period, the investor actually loses purchasing power.

How do we define liquidity risk?

It is that portion of an asset's total variability of return which results from price discounts given or sales commissions paid in order to sell the asset without delay. It is a situation wherein it may not be possible to sell the asset. Assets are disposed off at great inconvenience and cost in terms of money and time. Any asset that can be bought or sold quickly is said to be liquid. Failure to realize with minimum discount to its value of an asset is called liquidity risk.

What is meant by default risk?

The default risk arises due to the default in meeting the financial obligations as and when due for payment. The non-payment of interest and principal amounts in time will increase the risk of insolvency and bankruptcy costs. The default risk or insolvency risk will cause a sudden dip in company's stock prices.

How do we define callability risk?

It is that portion of security's total variability of returns that derives from the possibility that the issue may be called or redeemed before maturity. Callability risk commands a risk premium that comes in the form of a slightly higher average rate of return. This additional return should increase as the risk increases.

What is meant by Risk Management?

Risk management is the process of measuring or assessing risk and developing strategies to manage it. Risk management is a systematic approach in identifying, analyzing, and controlling areas or events with a potential for causing unwanted change. It is through risk management that risks to any specific program are assessed and systematically managed to reduce risk to an acceptable level. Risk management is the act or practice of controlling risk. It includes risk planning, assessing risk areas, developing risk handling options, monitoring risks to determine how risks have changed, and documenting the overall risk management program.

What are the objectives of Risk Management?

The objectives of risk management are as under:

(a) Anticipating the uncertainty and the degree of uncertainty of the events not happening the way they are planned.

(b) Channelizing events to happen the way they are planned.

(c) Setting right, at the earliest opportunity, deviations from plans, whenever they occur.

(d) Ensuring that the objective of the planned event is achieved by alternative means, when the means chosen proves wrong, and

(e) In case the expected event is frustrated, making the damage minimal.

What is the Risk Management process?

The steps are as under:

Step 1: Risk Identification and Assessment

This step involves event identification and the data collection process. The institution has to put in place a system of capturing information either through key risk drivers (KRIs) or through a rating system. Once risks are identified, combine like risks according to the following key areas impacted by the risks — people, mission, physical assets, financial assets, and customer/stakeholder trust.

Step 2: Risk Quantification and Measurement

The next step is to Quantify and Measure risks-this means Rate risks according to probability and impact. Various standard tools are used by financial institutions to measure risk and understand their impact in terms of capital or its importance to the organization through a scoring technique.

Step 3: Risk Analysis, Monitor, and Reporting

The next step is risk analysis, monitoring, and reporting. This will help one to get the big picture and decided on the

approach to risk management.

Step 4: Capital Allocation

Risk Analysis, Monitoring & Reporting sends information to the top management of the organization to take strategic decisions. Capital allocation plays a key role in management decision-making.

Step 5: Risk Management and Mitigation

After the above step, the last step is to make strategic decisions to manage the risk to mitigate the risk.

How is Enterprise Risk Management defined?

ERM is defined 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 risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives".

From the above definition, ERM is:

(a) A process, ongoing and following through an entity.

(b) Effected by people at every level of an organization.

(c) Applied in strategy-setting.

(d) Applied across the enterprise, at every level and unit, and includes taking an entity-level portfolio view of risk.

(e) Designed to identify potential events affecting the entity and manage risk within its risk appetite.

(f) Able to provide reasonable assurance to an entity's management and board.

(g) Geared to the achievement of objectives in one or more separate but overlapping categories.

ERM is about designing and implementing capabilities for managing the risks that matter. The greater the gaps in the current state and the desired future state of the organizations risk management capabilities, the greater the need for ERM infrastructure to facilitate the advancement of risk management capabilities overtime.

It is about establishing the oversight, control and discipline to drive continuous improvement of an entity's risk management capabilities in a changing operating environment.

It deals with risk and opportunities affecting value creation or preservation.

It is a comprehensive and integrated approach to addressing corporate risk.

It enables management to effectively deal with uncertainty and associated risk and opportunity, enhancing the capacity to build value.

In ERM, a risk is defined as a possible event or circumstance that can have negative influences on the enterprise in question. Its impact can be on the very existence, the resources (human and capital), the products and services, or the customers of the enterprise, as well as external impacts on society, markets, or the environment.

What are the steps related to ERM?

The steps are as follows:

- Control environment
- Risk Assessment
- Control activities
- Information and Communication
- Monitoring activities

What is Control environment?

Control environment

It creates a set of standards, processes, and structures that provide the basis for carrying out internal control.

The control environment comprises the *integrity* and *ethical* values of an organization, as well as:

a) Management's philosophy and operating style
b) Organizational structure
c) How management assigns authority and responsibility (both along functional and administrative reporting lines)
d) The competence of the entity's people.
e) Personnel development (including training and support)

The Control Environment should ensure controls are in place, covering areas such as:

- Clear lines of responsibility and authority
- Procurement policy
- Three-way match in vendor payments
- Code of Ethics
- Whistleblower policies
- Hiring practices
- Training programs

These processes need to be continuously monitored and updated.

What is Risk Assessment?

Risk Assessment

A Risk is a possibility that an event will occur and adversely affect the achievement of objectives.

Risks can be introduced by changes – for instance, new leaders and managers, new markets and products, growth, and emerging technologies.

Categories of risk

Risk is categorized into four key risk areas:

(1) **Strategic risk** includes the political risk, talent and succession planning risk, and risk from dependencies on other organizations.

(2) **Financial risk** includes the risk of audit findings and other things that would undermine reporting integrity.

(3) **Compliance risk** includes fraud and non-compliance with fair employment practices.

(4) **Operational risk** includes the risk that programs fail to meet their objectives, natural disasters, and lack of technology availability.

What are control activities?

Control activities

Control Activities are the actions established through policies and procedures that help ensure management's directives to mitigate risks are carried out. These activities are performed at all levels of the entity.

Control activities are exactly what they sound like – the *activity* part of the internal control framework. While the control environment and risk assessment set the stage for good controls, the control activities are where the meat of the control work is done.

Examples of control activities include:

- Approvals & Authorizations
- Embedded verifications

- Reconciliations
- Independent Reviews
- Asset security
- Segregation of duties

What are the categories of Control Activities?

Categories of control activities

(1) **Preventive controls:** Prevent the occurrence of a negative event proactively. Examples include the following:
   - Approval required for purchases greater than Rs.5,000
   - Passwords required for access to ERP system
   - Petty cash that must be held in a lockbox
   - Security and surveillance systems in high-risk areas, and
   - Pre-numbered invoices and checks

(2) **Detective controls:** Detect the occurrence of a negative event after the fact in a reactive manner. Examples include the following:
   - Supervisor review & approval
   - Reports that are run showing user activity
   - Reconciliation of petty cash
   - Annual Physical inventory counts, and
   - Review of missing and voided checks

(3) **Manual controls:** Require action to be taken by employees. Examples include the following:
   - Obtaining a supervisor's approval for overtime
   - Reconciling bank accounts, and
   - Matching receiving to Purchase Orders

(4) **Automated controls:** These are built into the network infrastructure and software applications. Examples include the following:
   - Passwords
   - Data entry validation checks, and
   - Batch controls

What is meant by Information and Communication?

Information and Communication

This component is pretty straightforward but is also very important in ensuring a cohesive, sustainable framework. Accurate, timely information is necessary to properly carry out internal control responsibilities in support of the achievement of an organization's objectives. Communication is the continual, iterative process of providing, sharing, and obtaining that necessary information.

Management and employees must be able to obtain information from both internal and external sources as necessary, and communication paths must be viable to both internal and external parties. Information should be timely, accessible, and allow for successful control actions.

The things to communicate:

- Initiatives

- Goals
- Changes
- Opportunities
- Feedback
- Questions
- Answers
- Policies
- Procedures
- Standards
- Expectations

What are monitoring activities?

Monitoring activities

Monitoring activities are evaluations used to ascertain whether components of internal control are *present* and *functioning*. These evaluations can be split into two categories:

1. **Ongoing** evaluations are built into business processes and provide timely information on the underlying controls.
2. **Separate** evaluations are conducted periodically and vary in scope and frequency based on prior assessments of risk, the effectiveness of *ongoing* evaluations, and other management considerations such as resource prioritization. Separate evaluations include Internal Audit activities.