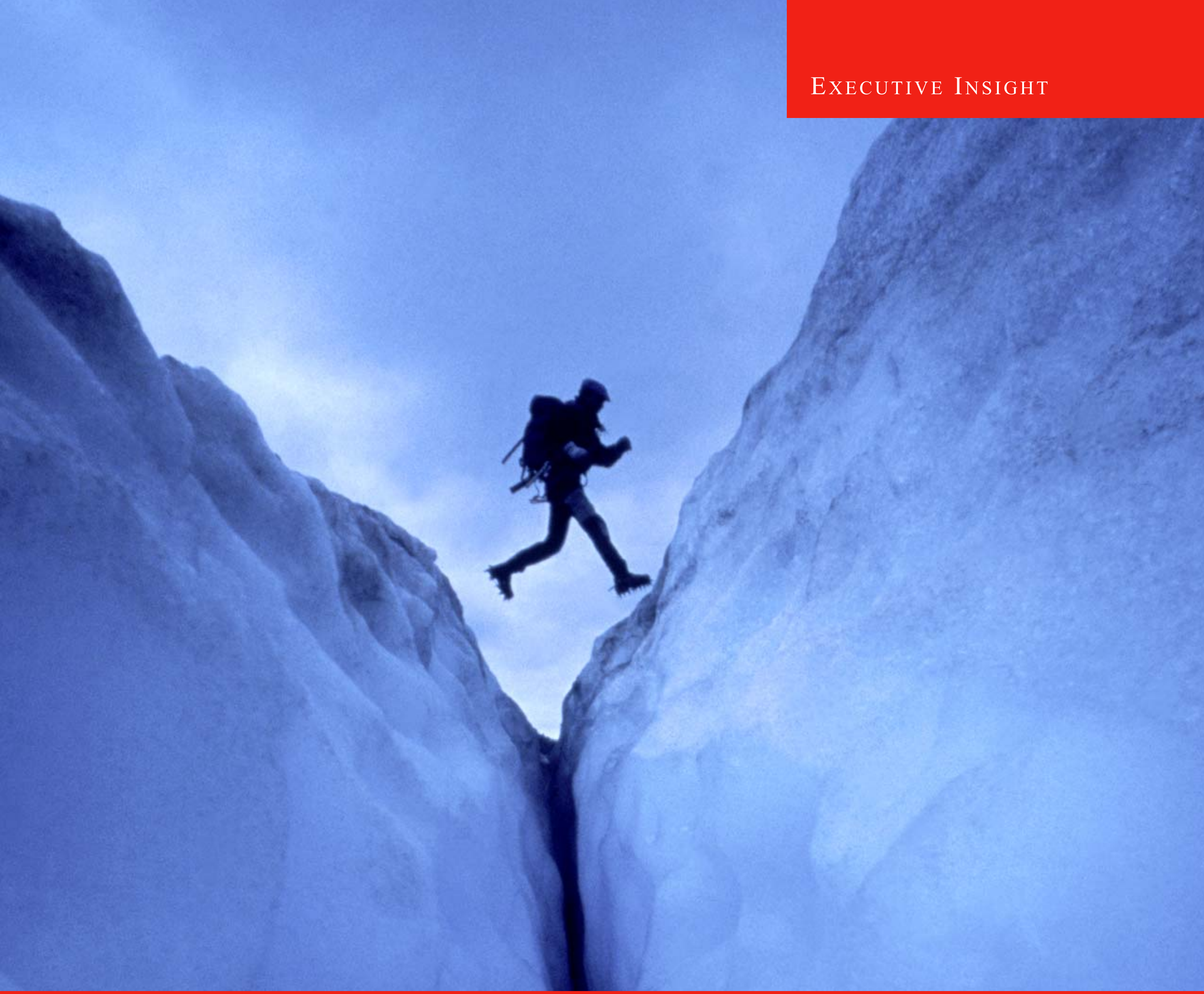
Executive Insight



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Managing Financial Risk

A Checklist for Board Members

To increase profitability while managing risk in today's business and regulatory environment, all companies must develop formal control and oversight procedures at the most senior levels.

In recent years, there has been much publicity about the losses associated with derivative instruments and other financial transactions. These incidents highlight the need to more clearly define the role of boards of directors in the corporate governance and oversight area. However, in many of these situations, board members might not have been sufficiently aware of the intricacies of the transactions to voice an informed opinion on their appropriateness.

By following two general guidelines, companies will propel themselves further along than many are today:

1. **Recognize the distinction in the use of the term "oversight" rather than "controls."** In some well-publicized instances, companies did have policies and procedures in place that prohibited the actions that caused the losses, yet transactions were executed despite these policies. Companies must recognize that it is not enough to have documentation declaring certain activities unacceptable; rather, they must also have an oversight process in place to ensure the effectiveness of internal controls and the enforcement of the policies and procedures. In short, they need a system of checks and balances that can ensure that unauthorized activities do not and cannot occur.
2. **Develop consistent measures for company-wide risk.** It's not possible or practical for each board member to have detailed knowledge of all aspects of complex financial transactions; nor is it wise to eliminate their use simply because this knowledge level is absent. Rather, measures of potential risk caused by transactions and underlying business exposures must be provided to senior management and the board to allow an assessment of whether this level of risk is appropriate for the company and its objectives.

Responsibility of the Board

The Sarbanes-Oxley Act formalizes the important role that the board must play in the risk-management process. The board's responsibility is to oversee an infrastructure that can define, analyze, measure, and report on the effective control of risk inherent in the company's underlying financial activities and the instruments used to manage risk. The output of this infrastructure must be synthesized into clearly defined and understood measures that the board can evaluate and, if necessary, impose its oversight. The methodology necessary to develop this infrastructure is where the responsibility of the board takes on greater dimensions. If it feels it lacks the expertise to analyze the underlying risk elements itself, it should consider going outside the company to find qualified, objective sources of assistance.

Board-level risk definition efforts should include the development of a customized measurement, evaluation, and reporting process that fits the company's:

- Risk tolerances
- Level of complexity
- View of materiality
- Degree of centralization or decentralization
- Desired level of detail

The board must design an iterative process and evolve to a best practices approach, meeting the needs of the company while taking into account its own limitations.

In addition to establishing a risk measurement and reporting process, the audit committee should ensure that management, working with internal and external auditors as appropriate, has a formal and structured process to periodically assess the internal control framework and its effectiveness. This should include documentation of processes and controls, as well as periodic testing to validate compliance. Finally, the finance or similar board committee should monitor financial transactions and risk-management performance, particularly where debt and investment transactions are involved.

To gain a better understanding of the level of detail behind the two general guidelines mentioned above, we offer the board-level checklist. While not all-inclusive, it's a good start and will set the company's thought process moving forward on these issues.

Board-Level Checklist For Financial Risk Management

- ☐ Do you have a written risk-management policy that includes a clearly defined and detailed implementation strategy approved by the proper levels of management?
- ☐ Does the risk-management policy identify the types of financial exposures facing the company and which exposures will be managed?
- ☐ Does the policy clearly define the underlying business rationale for the the company's derivative use, or does it leave open the possibility of speculative transactions?
- ☐ Does the policy define the company's risk limits and detail how they will be measured (e.g., scenario analysis, value-at-risk) and monitored on a periodic basis?
- ☐ Does the policy include approval levels for various dollar levels and types of transactions? If any of those transactions are complex or leveraged instruments, does the approval level cover their risk profile or just their simple face value?
- ☐ Is there clear reporting to senior management of the potential market, credit, and liquidity risk due to risk-management activities, and do these measures also separately indicate and measure the underlying business risks being managed?
- ☐ Are the risk-management objectives, policies, strategies, and risks clearly disclosed in the external reporting (e.g., annual report, 10K, etc.)?
- ☐ Is there an oversight function to ensure that policies and procedures are being implemented properly and risk limits are complied with? Does someone other than the individuals involved in the derivative instrument selection and execution head and supervise this function?

- ☐ Is there a consistent framework that the board (or appropriate board committee) members use to evaluate the risks, opportunities, and other relevant considerations of risk management or other financial transactions that are not specifically approved as part of the policy framework?
- ☐ Are there regular reviews performed by internal and external auditors who test and validate compliance with policies and procedures?
- ☐ Is there a clear segregation of duties between hedge execution and the settlement and accounting activities?
- ☐ Does a study of the derivative execution group's performance measures find that they actually encourage speculative or undesired behavior to improve performance?
- ☐ Do proper expertise and systems reside in-house to identify and quantify risk, as well as to price, evaluate, and report derivative/risk management positions?
- ☐ Is there an effective reporting system in place to inform proper levels of management of positions?
- ☐ Are the systems supporting the risk management activities secure?
- ☐ If risk-management expertise does not exist within the organization, has it been secured from knowledgeable and objective external sources?
- ☐ Are management reports on program status and performance measures received by senior management at least one level (if not two levels) higher than that required to approve transactions?
- ☐ Does the board periodically review the program's performance to ensure it is consistent with the risk profile of the company?
- ☐ Has the company considered the tax issues associated with the risk-management program?

Finally, companies should seriously consider engaging a business advisor to help address the issues on the checklist that may need particular attention.

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